EXAMINING THE DANGERS OF THE FSOC'S DESIGNATION PROCESS AND ITS IMPACT ON THE U.S. FINANCIAL SYSTEM

HEARING

BEFORE THE

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U.S. HOUSE OF REPRESENTATIVES

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EXAMINING THE DANGERS OF THE FSOC'S DESIGNATION PROCESS AND ITS IMPACT ON THE U.S. FINANCIAL SYSTEM

Tuesday, May 20, 2014

U.S. HOUSE OF REPRESENTATIVES,
COMMITTEE ON FINANCIAL SERVICES,
Washington, D.C.

The committee met, pursuant to notice, at 10:01 a.m., in room 2128, Rayburn House Office Building, Hon. Jeb Hensarling [chairman of the committee] presiding.

Members present: Representatives Hensarling, Bachus, Royce, Capito, Garrett, Neugebauer, McHenry, Pearce, Posey, Westmoreland, Luetkemeyer, Huizenga, Hurt, Stivers, Fincher, Stutzman, Hultgren, Ross, Pittenger, Barr, Cotton; Waters, Maloney, Sherman, Meeks, Hinojosa, McCarthy of New York, Lynch, Scott, Green, Moore, Ellison, Perlmutter, Himes, Peters, Carney, Sewell, Foster, Kildee, Delaney, Sinema, Beatty, Heck, and Horsford.

Chairman HENSARLING. The committee will come to order. Without objection, the Chair is authorized to declare a recess of the committee at any time.

The title of today's hearing is, "Examining the Dangers of the FSOC's Designation Process and Its Impact on the U.S. Financial System." I now recognize myself for 4 minutes to give an opening statement.

The committee's hearing today is on the Financial Stability Oversight Council which, like most Washington bureaucracies, has come to be known by its acronym, FSOC. FSOC was established, or so its supporters tell us, to make it easier for regulators to communicate and share information with each other. But the regulators didn't need an act of Congress to do that, and information-sharing is not what FSOC is really all about.

Instead, FSOC is about one thing: increasing Washington's control over the U.S. economy, thus curtailing both economic freedom and economic prosperity. And FSOC does this through its power to designate systemically important financial institutions, or in bureaucratic speak, SIFIs.

Having failed to prevent the last financial crisis, notwithstanding having every regulatory power necessary to do so, regulators were rewarded with even more power by the Dodd-Frank Act. The Dodd-Frank Act represents a breathtaking outsourcing of legislative power to the Executive Branch. Federal agencies now have virtually unfettered discretion to expand their regulatory control

through a designation process that is opaque, secretive, vague, open-ended, and highly subjective. And by empowering FSOC to designate SIFIs, Dodd-Frank allows the Federal Reserve to impose bank-like standards on nonbank institutions. In other words, to move institutions from the nonbailout economy to the bailout economy.

And that is what FSOC is doing, expanding the Fed's power to control the financial system using the pretext that size alone poses a systemic risk. Rather than offering up detailed data and compelling analysis to justify its efforts to commandeer large financial institutions, FSOC's perfunctory explanations are typical of an unaccountable group of agencies that feel they don't need to justify their actions to anyone.

Many think it odd that FSOC has chosen insurance companies and asset managers as targets for SIFI designation when there are others that clearly pose far greater risk to financial stability. Insurance companies are already heavily regulated at the State level, and asset managers operate with little leverage. And since they manage someone else's funds, it is almost inconceivable that an asset manager's failure could cause systemic risk.

In contrast, there were Fannie Mae and Freddie Mac, which were at the epicenter of the financial crisis. They were highly leveraged before the crisis and remain highly leveraged today. They are not only a source of systemic risk; they are its very embodiment. Then, there is the Federal Government itself. As I watch the national debt clock turn to my left and right, having borrowed upwards of $17 trillion, it is perhaps the most leveraged institution in world history, and, like charity, perhaps SIFI designation should begin at home.

Americans should also be worried that FSOC seems to take its direction from an international organization that meets secretly: the Financial Stability Board (FSB). Though the United States is represented, and I use that word advisedly, on this international board by the Treasury Department, the Federal Reserve, and the Securities and Exchange Commission, neither the Treasury, the Fed, nor the SEC has ever reported to Congress about its participation, nor have they ever asked for Congress' approval to participate in the global organization.

Now, while Administration officials are fond of invoking the risks that supposedly lurk in the so-called shadow banking system, great risks also lurk to U.S. financial stability and competitiveness in a shadow regulatory system in which Treasury and the Federal Reserve may have ceded U.S. sovereignty over financial regulatory matters to a secretive, unaccountable coalition of European bureaucrats. Just days ago, in this very hearing room, Secretary Lew refused to answer key questions regarding Treasury's participation in the FSB designation process.

To most Americans, the SIFI designation process may seem like a classic inside-the-Beltway exercise, but the stakes are enormous. Designation anoints institutions as too-big-to-fail. Today's designations are tomorrow's taxpayer-funded bailouts. Americans may find themselves paying more to insure their homes and their families. Investors who relied on mutual funds to save for their children's education or their own retirement will find they have earned less.

And our economy will suffer as sources of long-term investment capital dry up. I once again call upon FSOC to cease and desist further SIFI designations until Congress can review the entire matter.

I now yield 6 minutes to the ranking member for an opening statement.

Ms. WATERS. Thank you, Mr. Chairman.

Six years ago this March, our regulators were faced with the first of many difficult decisions related to the financial crisis: bail out Bear Stearns or risk its bankruptcy, spreading instability worldwide. This was the first of several interventions during an economic collapse that resulted in the destruction of trillions of dollars of wealth, millions of families' economic livelihood, and the world's confidence in our markets and our way of life.

Despite the revisionist views of my Republican colleagues, this crisis resulted in part from an inability of markets to police themselves, which was compounded by the inability of the previous Administration and regulators to stop predatory practices on Wall Street. At the end of the day, Wall Street's greed had disastrous effects on Main Street.

As we picked up the pieces, we learned that regulators lacked authority to regulate entire markets, such as the $600 trillion over-the-counter derivatives market. Even worse, they did not have a comprehensive understanding of the companies they regulated, like AIG. For example, State regulators were barred from regulating AIG's derivatives as insurance products, but at the same time neither Federal regulators, nor AIG's own executives, understood the massive risk it was taking.

Democrats responded to the massive vulnerabilities in our system by enacting the Wall Street Reform Act, which created the Financial Stability Oversight Council (FSOC) to identify such risks and take the steps necessary to prevent them from threatening our economic well-being. Because of the FSOC, supported by the Office of Financial Research (OFR), we now have a more complete view of the entire market, and when necessary the FSOC can subject financial firms to safeguards intended to prevent certain threats from harming the economy, and it can make recommendations to address risky activities or practices.

Congress determined as a starting point that the FSOC would look at all bank holding companies with more than $50 billion in assets, but also directed the Council to look more broadly. Any firm or activity whose unregulated risk could create an economic pandemic should be identified and dealt with now, before it is too late. To date, the FSOC has identified two insurance companies that fit the designation, AIG and Prudential, as well as a finance company, GE Capital.

It is important to note that these companies weren't just singled out without evidence. FSOC has provided an informative, detailed analysis that paints a picture of their exposure. For example, in the case of AIG, the FSOC determined that a large number of corporate and financial entities have significant exposure in its capacity as a global insurer and could suffer losses in the event of financial distress at AIG.

Now, while these designations must be made on a strong analytical basis, at the same time I support a strong appeals process if

industry stakeholders feel as if FSOC got it wrong. However, to date, I have not seen anything to suggest that FSOC's appeals process has failed. I have reviewed this appeals process with my staff, and I am convinced that the industries have an opportunity to make their case.

The financial crisis demonstrated a need for heightened supervision of nonbank financial institutions, not just in the United States, but globally as well. That is why I have been mystified to see FSOC's decisions criticized as forgone conclusions based on the recommendations of the international coordinating body, the Financial Stability Board. Not only is there not a shred of evidence that supports this theory, but these critics are missing the point. Constructive engagement by U.S. representatives with the Financial Stability Board and the global boards coordinating insurance and securities regulation promote our global financial stability.

Mr. Chairman, we in Congress have been clear that we expect FSOC's actions to be crafted in a way that mitigates specific risks. One-size-fits-all solutions are more likely to cause harm than promote stability. But I believe Congress must continue to support the Wall Street Reform Act, and as a result we must hold the FSOC accountable to its mission to prevent any one company or risky activity from ever threatening our livelihood again.

Mr. Chairman, I have talked with many representatives from the industries that are concerned about whether or not FSOC is attempting to treat them as banks, and I am sympathetic to that argument, and I am looking very closely to see if this is true. And I, again, support an appeals process where these companies have an opportunity to lay out their case and to challenge the FSOC, and I am looking to see how this is going to work, because I do believe that the industries have a right to question this, but I also believe that FSOC by law has a responsibility to mitigate risk in this country.

And with that, I yield back the balance of my time.

Chairman HENSARLING. The Chair now recognizes the gentleman from New Jersey, Mr. Garrett, the chairman of our Capital Markets and GSEs Subcommittee, for a minute and a half.

Mr. GARRETT. Thank you, Mr. Chairman.

I thank the witnesses for being here to share their knowledge and their insights on this important issue on FSOC. For some time now, this committee has been focused on the many failings of FSOC and its structure and its operation. We did that in hearings and letters and speeches, and we have asked FSOC for explanation and changes to address our concerns. So far, however, we have been met simply by stonewalling. Apparently some members of FSOC feel that public policy is best made under a blanket of secrecy and that argumentativeness is the best way to engage with Congress. The few answers that we do get are often strawman arguments that claim the only choices we have are FSOC's current way of doing things or nothing at all.

Well, I don't accept that. FSOC did not come down from heaven, perfect in every way, and there is certainly room for improvement. To that end, I have introduced H.R. 4387, the FSOC Transparency and Accountability Act. This bill subjects FSOC to the Sunshine Act and Federal Advisory Committee Act. It also allows all mem-

bers of the commission and boards represented on FSOC to attend and participate in the meetings. It also requires that an agency's vote represents the collective vote of the entire commission or board, not just the Chair. And finally, the bill permits members of the House Financial Services Committee and the Senate Banking Committee to attend FSOC meetings, as I have tried to do but was turned away in the past. So far, FSOC has done little to reassure this committee that it is a responsible body, and it would not be far-fetched to say that FSOC itself is one of the greatest threats to financial stability that we face today.

Finally, Mr. Chairman, I agree with the chairman that the FSOC should be refrained from any additional designations until we understand more about the process and impact of SIFI designation. And I yield back.

Chairman HENSARLING. The Chair now recognizes the gentleman from Massachusetts, Mr. Lynch, for 2 minutes.

Mr. LYNCH. Thank you, Mr. Chairman. I thank the ranking member, as well, and the witnesses for helping the committee with its work.

In the wake of the historical global financial crisis that cost the U.S. economy over $22 trillion, the landmark Dodd-Frank Wall Street Reform and Consumer Protection Act set systemic risk mitigation as one of the primary goals of comprehensive financial regulatory reform. To this end, Dodd-Frank created the Financial Stability Oversight Council (FSOC), which is a collaborative body designed to identify institutional sources of risk and instability within our financial system.

In furtherance of that mission, Section 113 of Dodd-Frank authorizes the Council to determine that a U.S. nonbank financial institution is systemically important upon a finding that, and this is a quote from the statute, "material financial distress at the company or the nature, scope, size, scale, concentration, interconnectedness, or mix of activities of the company could pose a threat to the financial stability of the U.S."

Mr. Chairman, I support the FSOC. I think it could be an institutional and collaborative force for stability in our financial markets. However, in order to better ensure that the Council's evaluation process for all our financial companies under Section 113 of Dodd-Frank reflects the seriousness of SIFI designation, I would urge the Council to make every effort to conduct its review in a manner that maximizes transparency and accountability without compromising the laudable goals of our financial reform efforts.

In addition, I would note that Dodd-Frank specifically contemplates that each financial company is different for the purposes of evaluating the risk it poses to the U.S. financial system. That is precisely why Dodd-Frank set forth the series of factors that the Council must consider in determining whether a nonbank financial institution is systemically important. These factors include the extent of a company's leverage and off-balance sheet exposures, the degree to which a company is already subject to regulation by one or more primary regulators, and the extent to which the assets are managed.

I see I am running out of time. I think that in many cases those factors tend to favor acquittal on behalf of some of our mutual

funds, and I just ask that FSOC take those recommendations to heart.

Chairman HENSARLING. The time of the gentleman has expired.

The Chair now recognizes the gentlelady from West Virginia, Mrs. Capito, the chairwoman of our Financial Institutions Subcommittee, for a minute and a half.

Mrs. CAPITO. Thank you, Mr. Chairman. And I want to thank the gentlemen for joining us for the hearing today.

As we have heard, the FSOC was originally envisioned as a mechanism for regulatory agencies to share information about potential risks, but it has morphed into an opaque entity that is subverting the prudential regulatory agencies by ignoring their expertise on specific industries that they are charged with supervising.

There are some very real economic consequences for many of the decisions that the FSOC is making, and this hearing will get to the heart of that. One of the tasks FSOC is charged with doing is designating nonbank SIFIs. In September of 2013, the FSOC designated a large life insurer as systemically significant despite extensive dissenting opinions from the FSOC's independent member having insurance experience. The one member of the FSOC who is charged with having a significant understanding of the industry argued that the FSOC's basis for the designation simply did not support the likelihood that the failure of the firm would cause disruption to the financial system. Furthermore, he argued that the majority of the FSOC that had approved the designation simply did not understand the basic fundamentals of the insurance industry.

Similarly, we will hear concerns about a one-size-fits-all approach to the regulation of financial institutions larger than $50 billion in assets. I have long been concerned about how the various asset designations and thresholds are designated in Dodd-Frank. We need to move past these ambiguous thresholds and change the regulatory agencies, charge them with determining the financial risk to the system based on the riskiness of their operations. I yield back.

Chairman HENSARLING. The Chair now recognizes the gentlelady from New York, Mrs. Maloney, the ranking member of our Capital Markets Subcommittee, for 2 minutes.

Mrs. MALONEY. I thank the chairman, and I apologize for being late. I was doing an event with Congressman Poe on the anti-trafficking, sex trafficking bills that will be on the Floor later on today, and which I hope will enjoy wide bipartisan support.

Mr. Chairman, one of the key lessons that we have learned from the financial crisis was that nonbank financial institutions that pose greater systemic risks need to be subject to stricter prudential standards. To implement this, Dodd-Frank created the Financial Stability Oversight Council, or FSOC, which is in charge of identifying the financial institutions that pose systemic risk and designating them as systemically important financial institutions (SIFIs). This is an important and necessary power, and without it we would have no protection against examples such as the AIG challenge that we faced.

However, the fact that this power to designate firms as systemically risky is so important also means that it should be exercised with great care, especially for firms that don't operate like tradi-

tional banks, like asset managers. We must also make sure that any proposed changes to the SIFI designation process do not hinder the FSOC's ability to carry out its mission of identifying and mitigating systemic risks in the financial system. Policymakers have to strike a careful balance between ensuring that there is a fair and thorough process for designating firms as systemically important on the one hand, and preserving the FSOC's ability to identify and mitigate systemic risk on the other hand.

I look forward to the hearing today, and I thank you very much. My time has expired.

Chairman HENSARLING. The Chair now recognizes the gentleman from Texas, Mr. Neugebauer, the chairman of our Housing and Insurance Subcommittee, for a minute and a half.

Mr. NEUGEBAUER. Thank you, Mr. Chairman, for holding this important hearing on the Financial Stability Oversight Council's designation process. The identification of nonbank systemically important firms is a serious exercise that has major implications for the competitiveness of U.S. firms and the stability of our financial markets.

This has been an area where I have been outspoken since the beginning, as I strongly believe FSOC's structure and its process for designating systemically important firms is fatally flawed. Rather than using data, history, and economic analysis to justify SIFI designations, FSOC has used far-fetched, highly speculative, worst-case scenarios to justify an aggressive expansion of regulatory power for Washington. In addition, many of the targets of this new regulatory overreach had nothing to do with the financial crisis and pose very little risk to financial stability.

No designation has been more symbolic of FSOC's flaws than the recent designation of an insurance company, Prudential Financial, as an SIFI. The Prudential designation ignored the expertise of the company's primary regulator, as well as FSOC's members specifically created to provide expert knowledge in the field of insurance. One of those members, Director John Huff, a State insurance commissioner from Missouri, recently stated that FSOC's misguided overreliance on bank concepts is nowhere more apparent than in FSOC's basis for designation of Prudential Financial. He went on to say that the basis for the designation was grounded in implausible, even absurd scenarios. The designated insurance expert, Mr. Roy Woodall, stated that the underlying analysis used by FSOC on the Prudential designation ran counter to fundamental and seasoned understanding of the business of insurance.

Chairman HENSARLING. The time of the gentleman has expired.

Finally, the Chair recognizes the gentleman from Missouri, Mr. Luetkemeyer, the vice chairman of our Financial Institutions Subcommittee, for a minute and a half.

Mr. LUETKEMEYER. Thank you, Mr. Chairman.

For the most part the SIFI designation process seems to be shrouded in secrecy. We have seen no meaningful metrics used in decisions, and Secretary Lew and other officials have refused to answer questions about the process. While the designation process is opaque at best for many firms, it is pretty straightforward for bank holding companies—straightforward and thoughtless. If an institution has more than $50 billion in assets, it is an SIFI. It doesn't

matter if a bank is smaller but engages in risky behavior or if a bank is larger but engages in no risky behavior. The only thing that matters is one arbitrary figure related to size. What kind of an evaluation is that?

I understand that common sense is in short supply in this town, but FSOC's designation process has serious implications on the financial system and needs to incorporate some element of logic and transparency. I look forward to the hearing with our witnesses today. And I yield back the balance of my time, Mr. Chairman.

Chairman HENSARLING. We now turn to our witnesses. The Honorable Paul Atkins is the CEO of Patomak Global Partners, a financial consulting firm. He previously served as a Member of the Congressional Oversight Panel for TARP and as a Commissioner on the Securities and Exchange Commission. Mr. Atkins holds a law degree from Vanderbilt University.

Mr. William McNabb is the chairman and CEO of the Vanguard Group, a position he has held since 2009. Before becoming CEO, Mr. McNabb served as managing director of Vanguard's institutional and international businesses. Today, we welcome his testimony on behalf of the Investment Company Institute.

Mr. Eugene Scalia is a partner at Gibson, Dunn & Crutcher, where he is co-chair of the firm's Administrative Law and Regulatory Practice Group. He earned his law degree from the University of Chicago.

Professor Michael Barr teaches financial institutions, international finance, and other aspects of financial law at the University of Michigan Law School. He previously served as Treasury Secretary Rubin's Special Assistant, and in other capacities at the Treasury Department. He earned his law degree from Yale Law School.

Mr. Deron Smithy is the treasurer of Regions Bank, which is based in Birmingham, Alabama. Today, we welcome his testimony on behalf of the Regional Bank Coalition.

Last but not least, and no stranger to our committee, Mr. Peter Wallison is the Arthur F. Burns Fellow in Financial Policy Studies at the American Enterprise Institute.

Without objection, each of your written statements will be made a part of the record. Hopefully, each of you is familiar with our green, yellow, and red lighting system on the witness table. I would ask each of you to please observe the 5-minute time allocation.

Mr. Atkins, you are now recognized for a summary of your testimony.

STATEMENT OF PAUL S. ATKINS, CHIEF EXECUTIVE OFFICER, PATOMAK GLOBAL PARTNERS

Mr. ATKINS. Thank you. Good morning. Mr. Chairman, Ranking Member Waters, and members of the committee, it is a pleasure to be back before you all today. As the chairman said, I believe you have my formal statement, and I know the chairman is a stickler for time, so I shall try to highlight a few of the central points.

But as a preliminary matter, I believe there is some clarification as to basic pronunciation that is in order. As you all know, Dodd-Frank gives the FSOC authority to label entities within the financial services industry as systemically important financial institu-

tions, abbreviated as S-I-F-I. Now, former chairman Barney Frank quipped the other day that "SIFFY," as with all due respect some people, including on the committee, have pronounced it, sounds like a disease, but that is because, I think, with all due respect, that there is a mispronunciation. So how does one pronounce this? It is WiFi, and this is hi-fi, and this is SIFI. And by no coincidence, it has a homonym, sci-fi. And SIFI designation I think is the statutory gateway to a new level, and for some entities a whole new world of potentially a twilight zone of regulation by the Federal Reserve.

I have two fundamental points. First, designating managed investment funds, particularly mutual funds, much less their advisers as SIFIs is a bad idea that lacks any demonstrated or I believe demonstrable analytic foundation. That point has nothing whatsoever to do with partisan politics or whether one is in favor of or opposed to Dodd-Frank.

Second, facts matter. Investment funds and investment management are fundamentally different from banks or the banking business. Bank regulators' prudential regulation of the largest mutual funds or their advisers will not be a complement, much less a viable substitute for the existing capital markets' regulatory regime.

Let me briefly touch on the two regulatory bodies affected. I am not here to defend the SEC's jurisdiction. If this were some sort of turf war, you wouldn't be hearing from me about it. The SEC is expert at regulating capital markets—risk markets. That is simply not what the Fed does, much less the FSOC. The Fed regulates to preferred outcomes. Central bankers are central planners. The SEC's entire experience and focus is on maintaining free and fair capital markets, while the Fed exists to ensure the safety and soundness, the continued viability of the banking system. So there is nothing in the Fed's 100-year history that even begins to suggest that applying prudential standards to capital market participants would be a benefit or that the Fed would be an effective capital markets regulator.

I want to underscore a further point in that connection. Were the Fed to impose capital requirements on SIFI-designated funds or even advisers, investors, notably ordinary individual investors saving for retirement or a downpayment in their 401(k) plans, would have to pony up or face Fed-imposed redemption restrictions. In fact, investment funds are overwhelmingly providers of capital. Mutual funds in particular tend to carry little or no leverage. A mutual fund does not transmit, but bears counterparty risk. To that extent, at least, mutual funds are the very opposite of the sort of highly leveraged entity enhanced Federal Reserve supervision was designed to address.

So what, in sum, could we expect if a mutual fund were designated an SIFI and subjected to the Fed's prudential supervision? Besides higher costs and lower returns, there will be less flexibility and more exposure to uncertain market risk. The Fed could constrain investors' ability to redeem their shares on demand or elect to require fund managers to remain in positions that they otherwise would have exited. Imagine that disclosure to investors?

Also, sound funds could be subjected to Fed demands to support failing banks under Dodd-Frank Section 210(o). Think of it as an

investor-funded “TARPs-are-us.” The unfortunate investors in SIFI funds would be at risk of supporting too-big-to-fail financial institutions under that section. None of this would provide any advantage to fund investors. Indeed, such Fed demands could easily force conflicts with the fund manager’s fiduciary duty to the fund and therefore to investors.

Moreover, if FSOC’s cavalier treatment of the insurance industry is any precedent, we should all be extremely concerned that equally misguided and uninformed treatment of regulated investment funds, notably mutual funds, is soon to follow. Any FSOC move to designate regulated investment funds as SIFIs lacks analytic foundation. There is nothing in last September’s self-serving—I would say sophomoric—OFR report (Office of Financial Research report) to suggest otherwise. And with that, my time has expired. Thank you.

[The prepared statement of Mr. Atkins can be found on page 60 of the appendix.]

Chairman HENSARLING. Mr. McNabb, you are now recognized for a summary of your testimony.

STATEMENT OF F. WILLIAM MCNABB III, CHAIRMAN AND CHIEF EXECUTIVE OFFICER, THE VANGUARD GROUP, INC., ON BEHALF OF THE INVESTMENT COMPANY INSTITUTE (ICI)

Mr. MCNABB. Thank you, Chairman Hensarling, and members of the committee, for the opportunity to participate in today’s hearing. I am Bill McNabb, chairman and CEO of the Vanguard Group, one of the world’s largest mutual fund organizations. We have some $2.6 trillion in U.S. mutual fund assets entrusted to us by everyday people saving for college, retirement, education, and other goals.

I appear today in my capacity as chairman of the Investment Company Institute. ICI’s membership includes U.S. mutual funds, exchange-traded funds, closed-end funds, and unit investment trusts with aggregate assets of nearly $17 trillion. ICI members are subject to substantial regulation and oversight by the SEC and other agencies, and we support appropriate regulation to ensure the resiliency and vibrancy of the global financial system. But we are deeply concerned about the way in which regulators in the United States and globally are considering large mutual funds and their managers for designation as SIFIs. The Financial Stability Oversight Council here in Washington, and the FSB operating globally, appear to be singling out large U.S. funds or their managers to subject them to an added burden of bank-style regulation.

Let me speak plainly. There is no justification for designating mutual funds or their managers as SIFIs. Stock and bond funds did not contribute to the financial crisis and do not pose threats to financial stability. If mutual funds or their managers are designated, millions of individual Americans could pay a tremendous price.

ICI is concerned that many of those involved in FSOC are predisposed to view the world through a banking lens. There are important fundamental differences between banks and funds. Unlike banks, fund managers act as agents, investing the money of others, not as principals putting their own capital at risk. Unlike bank depositors, fund investors understand they can lose money, and un-

like banks, funds operate without any need for government intervention.

There are several compelling reasons why even the largest funds are not SIFIs. First, mutual funds use little to no leverage, which is the essential fuel of most financial crises. The very largest U.S. funds have roughly 4 cents of debt for every dollar of shareholder equity. The largest U.S. banks by contrast have $9.70 of debt for every dollar of equity.

Second, funds don't experience financial distress that can threaten U.S. financial stability. Hundreds of funds exit the business every year, and none of them requires government intervention or assistance.

Third, stock and bond funds don't face so-called runs even in the most turbulent markets. While domestic stock funds own about 25 percent of U.S. stocks, their gross stock sales during the financial crisis represented less than 6 percent of market trading per month. If anything, these funds and their long-term investors have a dampening effect on market volatility. They enjoy a stable investor base because 95 percent of assets in stock and bond funds are held by everyday households, and virtually all of those households report that they are investing for long-term goals, such as retirement and education.

Fourth, the structure and comprehensive regulation of mutual funds limits risk and the transmission of risk. For example, daily valuation of fund portfolios, portfolio liquidity requirements, limits on borrowing, and simple transparent structures are among the features that both protect investors and limit risk. If the FSOC designates funds as SIFIs, the consequences for investors would be severe. Under Dodd-Frank, a designated fund could be subject to bank-level capital requirements with investors bearing the cost through higher fees and lower returns.

It is particularly troubling that investors in a designated fund could be forced to help shoulder the costs of bailing out large failing financial institutions under the orderly liquidation provisions. This is essentially a tax on retail investors, and Congress wrote Dodd-Frank specifically to avoid burdening taxpayers with these costs.

We are also concerned that the Federal Reserve's prudential supervision could conflict with a fund manager's fiduciary duty to act in the best interests of the fund. To protect the stability of the banking system, the Fed might pressure a fund manager to stay in certain markets or to maintain financing for troubled institutions, even if the manager believes those actions would harm investors. We don't believe that Congress created Dodd-Frank to target funds or to appoint the Fed as a significant capital markets regulator, and it is clear to us that SIFI designation, which was intended to be used quite sparingly, is not the right tool for addressing risk in these markets. If regulators believe specific activities or practices pose risk, they appropriately have considerable authority to address those risks.

Members of this committee from both sides of the aisle have focused a great deal of attention on the FSOC's lack of transparency and vague processes. We share your concern. Mr. Chairman, we agree that FSOC should cease and desist on further designations until Congress can better understand the process.

Thank you, and I will be happy to take questions at the appropriate time.

[The prepared statement of Mr. McNabb can be found on page 73 of the appendix.]

Chairman HENSARLING. Mr. Scalia, you are now recognized for 5 minutes.

STATEMENT OF EUGENE SCALIA, PARTNER, GIBSON, DUNN & CRUTCHER LLP

Mr. SCALIA. Mr. Chairman, Ranking Member Waters, and members of the committee, thank you for the opportunity to testify today regarding the Financial Stability Oversight Council. I am a lawyer at the firm of Gibson, Dunn & Crutcher, and this morning I would like to offer a few observations on FSOC from the perspective of the requirements of administrative law.

The FSOC designation process is an unusual one. If there is a similar process before another government agency, I am unaware of it. The process begins with a company being told that it is being considered for designation. It is not told why, yet it is singled out and considered on a solitary and secretive basis. This is very different than a rulemaking, for instance, where the companies in an industry are publicly told that the government is considering changing the requirements that apply to them, and what follows is an open and public discussion about the proper outcome.

A company that has been notified of potential designation is kept in the dark in at least two ways. First, the process itself is largely closed and unknown to the company. Until the very late stages it does not know why it is being considered, it does not know what opinions have been formed about it or what concerns and tentative conclusions have been reached. FSOC compiles extensive information on the company. None of that information is shared until after the FSOC members' proposed designation. Access to FSOC decision-makers is closely guarded, and as a practical matter is impossible.

Second, the company has inadequate notice on the legal standards that will be applied to it. As a Nation, we value fair notice to the public of their legal obligations for two principal reasons. First, when we are told what the law is, we are able to conform our conduct to comply in order to avoid sanctions. Second, when the government commits itself in writing to what the law is, it limits its discretion and power, and that in turn helps prevent arbitrary government conduct.

When it comes to SIFI designation, though, FSOC has done little more than list numerous factors it will consider without identifying the relative weight the factors will be given or what constitutes a passing grade under any one factor. Moreover, its SIFI designation decisions to date have applied such loose and subjective reasoning that other companies being considered have no way of knowing whether they will be designated or what changes they could make so they are not designated.

This brings me to the substance of FSOC's designation decisions to date as reflected in the leading Prudential decision. That decision is an exceptionally weak specimen of regulatory reasoning by a government agency. I do not believe it would have survived re-

view in a court. The problems with their decision are addressed at length in my written testimony. They include unsubstantiated conjecture; a subjective, standardless notion of excessive risk; and repeated disregard, as a number of you have mentioned, for the existing system of insurance regulation by the States.

I want to conclude by emphasizing another aspect of the FSOC designation process that is very unusual and is a terrible way to make government decisions. FSOC is not considering the consequences of its actions. It is singling out individual companies and subjecting them to an entirely new regulatory regime without knowing what effect that regulatory framework will have. Suppose that just two or three companies in a robustly competitive industry are designated systemic, and suppose that SIFI designation will subject those companies to significantly more costly regulatory requirements than their competitors. Those increased costs should be an extremely important consideration for FSOC. Remember, designation is supposed to be buttressing companies, supposed to be shoring them up, but what if it actually weakens them by making them less competitive? In that case, SIFI designation may be doing exactly the opposite of what is intended.

The government should never act without considering the consequences of its action. That is elementary. But FSOC does not make the consequences of designation part of its decision-making process. Worse, FSOC does not know what regulatory requirements will result from designation. It does not know what capital standards will apply to companies that are designated, although it has every reason to believe that under current law, those capital standards will be essentially bank-based, which are improper for other financial firms, such as insurance companies.

Before asserting that designation is appropriate because it will bring better protections, the government must determine what those protections are and what effects they will have. Until then, designation decisions are premature.

I want to conclude by commending the members of this committee for bringing attention to these issues. Our system of government rests on the belief that the government makes better, fairer decisions when it acts openly, through processes where the public, including Congress, have insight and input. Thank you for inviting me to speak here today, and I look forward to your questions.

[The prepared statement of Mr. Scalia can be found on page 88 of the appendix.]

Chairman HENSARLING. Professor Barr, you are now recognized for 5 minutes.

STATEMENT OF MICHAEL S. BARR, PROFESSOR OF LAW, THE UNIVERSITY OF MICHIGAN LAW SCHOOL

Mr. BARR. Thank you, Mr. Chairman, and Ranking Member Waters. I am pleased to appear before you today to discuss the key role of the Financial Stability Oversight Council in reducing risks in the financial system.

In 2008, the United States plunged into a severe financial crisis that shuttered American businesses and cost millions of households their jobs, their homes, and their livelihoods. The crisis called for a strong response. Under the Dodd-Frank Act, there is new author-

ity to regulate major firms that pose a threat to financial stability without regard to their corporate form; to wind down such firms in the event of a crisis without feeding a panic or putting taxpayers on the hook; to attack regulatory arbitrage, restrict risky activities, and beef up supervision; to require central clearing and exchange trading of standardized derivatives, and capital, margin, and transparency throughout the market; to improve investor protections; and to establish a new Consumer Financial Protection Bureau to look out for American families.

The Act also established a Financial Stability Oversight Council, with the authority to designate systemically important firms and financial market utilities for heightened prudential oversight, to recommend that member agencies put in place higher prudential standards when warranted, and to look out for risks across the financial system.

One of the major problems in the lead-up to the financial crisis was there was not a coherent system of supervision for major financial institutions. The Federal financial regulatory system that existed was broken. Major financial firms were regulated according to their formal labels, as banks, thrifts, investment banks, insurance companies, and the like, rather than according to what they actually did. Risk migrated to the less well-regulated parts of the system and leverage grew to dangerous levels.

The designation of systemically important financial institutions is a cornerstone of the Dodd-Frank Act. A key goal of reform was to create a system of supervision which ensured that if an institution posed a risk to the financial system, it would be regulated, supervised, and have capital requirements that reflected its risk regardless of its corporate form. The Dodd-Frank Act established a process through which the largest and most interconnected firms could be designated as systemically important and then supervised and regulated by the Fed.

The Council has developed detailed rules, interpretive guidance, and a hearing process, including extensive engagement with affected firms, to implement this designation process. The existing rules provide for a sound deliberative process, protection of confidential and proprietary information, and meaningful and timely participation by affected firms.

Critics of designation contend that it fosters too-big-to-fail, but the opposite is the case. Regulating systemically important firms reduces the risk that failure could harm the real economy and destabilize the financial system. It provides for robust supervision in advance and provides for a mechanism to wind down such a firm in the event of a crisis.

Other critics argue that the FSOC should be more beholden to the regulatory agencies that are its members, but again the opposite is true. Congress wisely provided for its voting members, all of whom are confirmed by the Senate, to participate based on their individual assessment of risks in the financial system, not based on the position of their individual agencies, however comprised.

Some critics also contend that certain types of firms in certain industries or under certain sizes should be categorically walled off from heightened prudential supervision, but such steps will expose the United States to the very risks we faced in the lead-up to the

last devastating crisis. The failure of firms of diverse types and diverse sizes at many points, even in very recent memory, from Long-Term Capital Management to Lehman and AIG, suggests that blind spots in the system should at the very least not be intentionally chosen in advance by the Congress.

The way to deal with the diversity of sizes and types of institutions is to develop regulation, oversight, and capital requirements that are graduated and tailored to the types of risks that such firms might pose to the financial system. Beyond designation, FSOC and member agencies have other tools available, including increased data collection, transparency, collateral and margin rules, operational and client safeguards, risk management standards, and other measures that can be used in appropriate circumstances.

Lastly, some critics complain that the FSOC's work is too tied to global reforms, including reforms by the Financial Stability Board, but global coordination is essential to making the financial system safer. And these global efforts are not binding on the United States. Rather, the FSOC and U.S. regulators make independent regulatory judgments about domestic implementation based on U.S. law.

In sum, significant progress has been made in making the financial system safer and fairer and better focused on serving households, businesses, and the real economy. Now is not the time to turn it back.

[The prepared statement of Mr. Barr can be found on page 70 of the appendix.]

Chairman HENSARLING. Thank you.

The Chair now recognizes Mr. Smithy for 5 minutes.

STATEMENT OF DERON SMITHY, TREASURER, REGIONS BANK, ON BEHALF OF THE REGIONAL BANK COALITION

Mr. SMITHY. Good morning, Chairman Hensarling, Ranking Member Waters, and members of the Financial Services Committee. My name is Deron Smithy, and I am the treasurer of Regions Bank, based in Birmingham, Alabama. I appreciate the opportunity to speak to the committee about the systemic risk designation, its impact on regional banks, and the ways in which it can be improved.

Regions Bank is a member of the Regional Bank Coalition, a group of 18 traditional lending institutions that play a critical role in the Main Street economy. Each of these banks are larger than $50 billion in assets, but operate basic, straightforward businesses that do not individually threaten the U.S. financial system. Regions Bank, for example, is a diversified, community-focused lender offering a full range of consumer and business lending products and services in 16 States. We have a time-honored and relatively simple operating model that focuses on relationship banking, matching high-quality customer service with industry expertise. Regions serves more than 500,000 commercial customers, including 450,000 small business owners, and we bank nearly 4.5 million consumer households.

Collectively, the banks in our coalition operate in all 50 States, hold one-fourth of the U.S. banking deposits, and have credit rela-

tionships with more than 60 million American households, yet no regional bank maintains a national deposit share greater than 3 percent of total deposits. In aggregate, our asset base is less than 2 percent of GDP, roughly equivalent to that of the single largest U.S. bank. We are traditional banks that fund ourselves primarily through deposits, and we loan those deposits back into our communities.

Regional banks are an important source of credit to small and medium-sized firms, competing against banks of all sizes throughout our markets. Regional banks are not complex. We do not engage in significant trading or international activities, make markets in securities, or have meaningful interconnections with other financial firms. Regional banks are not systemic and do not threaten U.S. financial stability.

The Dodd-Frank Act adopted a blunt definition of systemic risk for banks, relying on a simple $50 billion asset threshold. I would note Federal Reserve Governor Tarullo's recent speech in which he highlighted the need to rationalize the regulatory structures so that regulators can more precisely consider differences among firms. He questioned many of the existing bright line, asset-only thresholds and contended that the aims of prudential regulation should vary according to the business activities. He also suggested that the 80-plus banks larger than $10 billion, but those not deemed global systemically important, are overwhelmingly recognizable as traditional commercial banks.

On these points we would agree with Governor Tarullo, and we would support the bipartisan bill, H.R. 4060, introduced by Congressman Luetkemeyer and five other members of the committee. The bill would have regulators review five factors—size, complexity, interconnectedness, international activity, and substitutability—before making a systemic designation. All are factors that regulators have used in other contexts to determine how firms might impact U.S. financial stability.

Regional banks constantly react to regulatory and policy changes made in Washington, and these rules affect how we manage our organizations. Systemic regulation has both direct and indirect cost, and for individual regional banks these costs add up to hundreds of millions of dollars each year. They impact how we lend and how we price credit.

Even absent systemic designation, protective regulatory guardrails that have evolved since the financial crisis would remain in place for regional banks. The Federal Reserve has the authority to continue the capital planning and stress testing processes started before Dodd-Frank. Moreover, regional banks would remain subject to new Basel III capital and liquidity requirements, as well as numerous other rules outside of Title I's enhanced prudential standards.

To reiterate, the current designation process is imprecise and the costs incurred by regional banks are not commensurate with its impacts. Regional bank activities do not threaten the country's financial stability, nor are we complex organizations that would be difficult to resolve in a crisis. The current standard does not best serve the banks, taxpayers, and communities we serve, or the regulators. The regulators have requested clearer, less ambiguous ways

to determine systemic risk. A multifactor, activity-based test would do this.

Thank you again for the opportunity to testify before the committee today, and I look forward to answering any questions you may have.

[The prepared statement of Mr. Smithy can be found on page 105 of the appendix.]

Chairman HENSARLING. To bat cleanup, Mr. Wallison, you are now recognized for your testimony.

STATEMENT OF PETER J. WALLISON, ARTHUR F. BURNS FELLOW IN FINANCIAL POLICY STUDIES, THE AMERICAN ENTERPRISE INSTITUTE

Mr. WALLISON. Thank you, Mr. Chairman, Ranking Member Waters, and members of the committee. Thank you for the opportunity to testify this morning.

Under Dodd-Frank, the Financial Stability Oversight Council (FSOC) has the authority to designate any nonbank financial firm as a systemically important financial institution, or SIFI. That is if the institution's financial distress will cause instability in the U.S. financial system. Firms designated as SIFIs are turned over to the Fed for what appears to be bank-like regulation.

The troubling aspects of the FSOC's authority were revealed recently when it designated Prudential Financial as an SIFI. Every FSOC member who was expert in insurance and not an employee of the Treasury Department itself dissented from that decision. Virtually all of the other members, knowing nothing about insurance or insurance regulation, dutifully voted in favor of Prudential's designation.

Now, how could we entrust the decision to regulate a large insurer like a bank to a group with no expertise about insurance regulation, and when the FSOC could not possibly have known how the Fed would actually regulate an insurance firm?

Even more troubling was the fact that the FSOC offered no facts, no analysis, and no standards in support of its decision. For example, interconnections are supposed to be one of the main reasons that SIFIs are SIFIs. All financial institutions are interconnected in some way, but the FSOC's Prudential decision says nothing about the degree of Prudential's interconnections or why they are a danger to the financial system. The same is true of all the other prior FSOC designations.

Let me say it plainly: On the evidence of the Prudential decision, this emperor has no clothes. The FSOC seems to have no idea how to assess the danger of interconnections or any of the other reasons that SIFIs are considered such a threat to the financial stability that they require Fed bank-like regulation. This means the decisions are completely arbitrary. And since these decisions have a seriously adverse effect on competition and economic growth, they should not be allowed to continue until the FSOC can explain its decisions to Congress.

There are other reasons to be concerned. Two months before the FSOC's Prudential decision, the Financial Stability Board (FSB), an international body of regulators empowered by the G-20 leaders to reform the international financial system, had already declared

Prudential an SIFI, also without facts and analysis. Since the Treasury and the Fed are members of the FSB, they had already approved the FSB's designation well before the FSOC designated Prudential as an SIFI in September.

This raises two questions: first, the fairness and objectivity of the FSOC's designation process; and second, whether the FSOC will simply rubber-stamp the decisions of the FSB in the future. This is important because the FSB looks to be a very aggressive source of new regulation of nonbank financial firms.

In early September, the FSB published plans to apply what it called its SIFI Framework to securities firms, finance companies, asset managers, and investment funds, including hedge funds. These firms are the so-called shadow banks that bank regulators are so eager to regulate. It will be very difficult to show that these nonbank firms are a threat to the financial system, but the Prudential decision shows that neither the FSB, nor the FSOC believes it has any obligation to demonstrate this.

The question before this committee is not solely whether investment funds are SIFIs. The FSB has already suggested it will apply the SIFI Framework to securities firms, mutual funds, hedge funds, and many, many others. If the FSOC follows suit, and that has been the pattern, we may see many of the largest nonbank firms in the U.S. financial system brought under bank-like regulation.

As shown in my prepared testimony, these capital markets firms and not the banks are the main funding sources for U.S. business. Subjecting them to bank-like regulation will reduce their risk-taking and innovation and thus have a disastrous effect on competition and economic growth, and this outcome would be the result of decisions by the FSB carried out by the FSOC.

About 2 weeks ago, Mr. Chairman, you said that the FSOC should cease and desist on designations until Congress can assess the consequences. I hope that request is honored.

[The prepared statement of Mr. Wallison can be found on page 118 of the appendix.]

Chairman HENSARLING. Thank you.

The Chair now recognizes himself for 5 minutes for questioning.

Mr. McNabb, you run one of the largest mutual fund companies in America. I assume there are a lot of mom and pops who entrust their savings with you to send somebody to college, maybe start a small business, maybe plan for retirement.

Recently, I had a study come across my desk by Douglas Holtz-Eakin, the former Director of the Congressional Budget Office, which estimated that designating asset managers as SIFIs—sorry, Mr. Atkins, I am not sure the "sci-fi" is going to catch on, but it was compelling—over the lifetime of their investment, their investment portfolio could be hurt by as much as 25 percent, $108,000 per investor.

Have you seen this study? Have your people analyzed it? And if that is in the ballpark, knowing that you deal with a lot of hard-working Americans' savings, what is this SIFI designation going to mean to the individual trying to save for retirement or send a kid to college?

Mr. MCNABB. Thank you for the question, Mr. Chairman. You are right. We do serve a lot of mom and pops. We have 25 million investors, roughly, scattered around the country. Savings for retirement and for education would be the two primary reasons.

I actually have a copy of that study; it just came across my desk yesterday. I am guessing the numbers are actually conservative in terms of the calculations because they did it as a one-time—they looked at a one-time investment and what would the consequences of bank-like capital be on the accrual of the account, if you will, and the estimate was that over a long period of time, the account value would be 75 percent of what it would have been were there no capital requirements.

We have also looked at a couple of other analyses that are similar, where instead of looking at capital requirements, we looked at some of the proposed so-called SIFI taxes. In those cases, if you are an investor, for example, in our S&P 500 Fund, which is one of the more basic funds we offer, your fees would quadruple. And at that level, it would be pretty disastrous for many investors.

Chairman HENSARLING. Mr. Wallison, as I was listening to your testimony, I think you said to some extent that the decision-making formula for FSOC to designate a nonbank SIFI was completely arbitrary. You mentioned about the G-20 Financial Stability Board, their process that designated, I think, three U.S. insurers as global SIFIs. Wasn't it, I don't know, 10 or 12 days ago that we had Secretary Lew in this hearing room where I asked him, as head of FSOC, did Treasury consent or object to these designations? He refused to answer the question 3 different times. I suppose there is a possibility their representatives fell asleep during the proceedings and neither objected or consented. So that would seem to suggest that either the United States adopted whatever the criteria is of SSB, or they have their own, but yet they refuse to reveal it. I am not sure that anyone has been able to discern what this approach is.

I noticed that yesterday, Treasury Under Secretary Mary Miller said that she was surprised that anyone would believe that FSOC is considering possibly designating the asset management industry as an SIFI. And she was quite adamant that FSOC did not follow the G-20's Financial Stability Board's designation of these three U.S. insurers.

How credible is it to you that the FSB would have made these designations without the consent of Treasury and other U.S. participants?

Mr. WALLISON. It seems to me completely unreasonable to believe that the FSB would go ahead with a designation of U.S. firms without the agreement of the U.S. participants, particularly the Treasury Department and the Fed.

Chairman HENSARLING. What concerns do you have if the United States would continue to follow the FSB's lead?

Mr. WALLISON. I have a very serious concern about process here, because at least in the banking area, the Basel capital requirements are put into place by a group of regulators, and then they are put into place by the U.S. bank regulators here in the United States. I am afraid that some people are looking at the process of the FSB as similar to the bank capital process that is undertaken

in Basel, and if that is so, they are expecting at the FSB that once they designate an institution as an SIFI, the FSOC here in the United States will simply take that designation and apply it in the United States.

That is not, I think, what Congress intended when it set up the FSOC and expected some kind of analysis. And it is not getting that analysis anyway.

Chairman HENSARLING. The Chair needs to gavel himself down.

The Chair now recognizes the ranking member, Ms. Waters, for 5 minutes.

Ms. WATERS. Thank you very much, Mr. Chairman.

Mr. McNabb, I spent a considerable amount of time following this subprime meltdown that we had in this country, and I worked very hard to convince a lot of people, despite the fact I and others were criticized for it, to do this bailout because we felt that this country's economic future was at stake. And we felt that the recession could morph into a depression, and so we worked very hard to try and do what we thought was the best thing.

In all of the work that we were doing, AIG, for example, emerged as a real problem, an insurance company. So my decision about whether or not I support FSOC being able to take a look at nonbank companies is based on some of what I learned during that awful period of time that we went through.

Now, we find that AIG again is designated as an SIFI, and so I want to understand from you why you think FSOC is wrong in taking a look at something like AIG. It doesn't have to be specific, but I use that as an example.

Mr. MCNABB. Thank you, Ranking Member Waters.

The AIG question actually, I think, highlights an important point. When you look at what happened at AIG, it was the activities at the firm. AIG had morphed into much more than an insurance company, and it was the activities that really led to their demise. The activities were extraordinary leverage and excessive risk-taking. And I would say both those kinds of activities have been present in almost every financial crisis going back 500 years.

When we talk about the mutual fund industry, as an example, funds employ no leverage. And the other difference, of course, is that funds are acting as agents as opposed to proprietary traders and so forth, and that is a very big difference.

And so the activities that drove AIG to the brink are certainly the kinds of activities that should be looked at. But it is not really based on the firm, it is really the leverage and the activities, much as my colleague Mr. Smithy here on the panel suggested regarding the regional banks.

Ms. WATERS. So you don't think that AIG, Prudential, as well as maybe GE Capital should be designated?

Mr. MCNABB. I am not expert enough on GE Capital or Prudential. Again, my take would be to look at the factors that make those firms either more risky or less risky. And it is not the firm's size or even the assets under—

Ms. WATERS. It is about risk, Mr. McNabb.

I want to move to Mr. Barr now. Mr. Barr, I have heard a lot about the incompetence of FSOC. They don't know what they are

doing, they don't know how to regulate or determine risk of insurance companies, et cetera.

Do you agree that the FSOC has both the expertise and the authority to appropriately assess nonbank financial institutions such as insurance companies? Do they have the authority and the expertise?

Mr. BARR. I believe they do, Ranking Member Waters. I believe that the FSOC has developed a quite extensive staff and expertise across the financial sector. They could always do more. I think the process of building expertise in a new agency is a challenging one. I think they should do more to build up their staff and the staff of the independent Office of Financial Research as well.

But they certainly have the authority, and they have plenty of people with experience.

Ms. WATERS. Mr. Wallison, you made quite a point of talking about the lack of competence and expertise at the FSOC. If they were competent, if they had the expertise, if they could be designed in a way that you would design them, do you think there should be an FSOC?

Mr. WALLISON. Yes, I always thought there should be an opportunity, as there was with the Presidential Council that used to meet and talk about common problems in the regulatory area. And, in fact, something like FSOC could get together and talk about whether they think that there are systemic issues developing in the economy.

My problem with FSOC is that it has the power to make decisions to turn over certain institutions to the Fed for bank-like regulation without even knowing what bank-like regulation would be, for example, for an insurance company, and without actually showing us the basis for those decisions.

If we think about those decisions, they have to do with the future. Will a firm's distress cause instability in the U.S. economy? Those are guesses about the future, and if they provide no data about what they think will happen, I don't think this is a credible decision.

Chairman HENSARLING. The time of the gentlelady has expired.

The Chair now recognizes the gentleman from New Jersey, Mr. Garrett, the chairman of our Capital Markets Subcommittee, for 5 minutes.

Mr. GARRETT. Thanks, Mr. Chairman.

Mr. Wallison, can you briefly say, in your view, does SIFI designation reinforce too-big-to-fail?

Mr. WALLISON. Yes, I think that is one of the problems with it, of course, and that is once you are said to be an institution whose failure might cause the instability in the United States economy, you are saying it is too-big-to-fail.

Mr. GARRETT. Right.

You heard the testimony of Professor Barr. He seemed to be saying that all is well with FSOC, with their expertise and the like. Do you concur?

Mr. WALLISON. I don't know any of the experts they have, but if you look at the decision that they made in the Prudential case, they provided no data that would suggest that they are experts. And—

Mr. GARRETT. That is a good point. So, Professor Barr, you just said a minute ago that they had the expertise, and you referred to the OFR. Have you read the OFR report that was—but for the fact that SEC put it up on their Web site would not have been disclosed? Have you looked at that? And is that what you base the fact that you think they have the expertise to do the job?

Mr. BARR. I believe the question was asked about the expertise of the FSOC, which I think is strong. I think the OFR is a new organization and is still building.

Mr. GARRETT. You referred back to them and said—you referred back and said one of their bases of expertise is the OFR. So have you looked at the report?

Mr. BARR. Yes, I have.

Mr. GARRETT. And do you know that virtually every one of the commentators on there have basically criticized it and said there is absolutely no empirical data in it? Did you find empirical data it in?

Mr. BARR. The report was not something I would hang my hat on.

Mr. GARRETT. All right. So, you wouldn't hang your hat on it, but apparently FSOC hung their hat on it. So if that is—

Mr. BARR. I have no idea—sorry, sir, to interrupt—one way or another about that.

Mr. GARRETT. That is a good point. So then, how can you say that they are acting with empirical data if you are not able to say, and we are not able to say, and I think that is Mr. Wallison's and Mr. Atkins' points as well, that when we look at FSOC, we cannot figure out what are their facts, what is their analysis, and what are their standards? And if we can't figure those things out from FSOC, how can you sit there and say that they are operating with facts, analysis, and standards?

Mr. BARR. I am not privy to the internal processes at all of what is going on at the FSOC, but my understanding is they have not acted in any way with respect to some designation of asset managers. So I have no way of knowing one way or the other the extent to which the OFR report may or may not play a role in that process.

Mr. GARRETT. And isn't that really the point? That not only are you not privy to it, Members of Congress are not privy to it. I guess no one actually is privy to it. Even commissioners from the various agencies where the chairmen are members of are not privy to it.

And I think that is one of the simple things that we could do is to allow the American public to be privy to this information, to be privy to how they make the decisions, what the facts are, what the analysis is.

Mr. Atkins, would you agree that this sort of information by FSOC, how they make this, what the standards are, should be open to the American public and the industry as well?

Mr. ATKINS. Absolutely, Congressman Garrett.

Mr. GARRETT. Why is that?

Mr. ATKINS. Because when you look at it—this goes back to the essence of bank regulation, I think, versus other sorts of regulation—it comes down to transparency. And bank regulators love, because they are focusing on safety and soundness, to lurk in the

shadows and do their regulation not in the broad daylight like other regulators do. I think that is part of the problem here with the FSOC.

Mr. GARRETT. I have a bill out there, and basically it would subject FSOC to the Sunshine Act and the Federal Advisory Committee Act. I will just throw this out to the whole panel.

Is there anybody on the panel who would say that there should not be more transparency with FSOC? Is there anybody on the panel who would say that they should not have to operate like just about every other agency in the Federal Government and have a little bit of sunshine? Does anybody disagree with more transparency at FSOC?

Mr. BARR. I think, Mr. Garrett, there ought to be regularized processes and transparency. I am not sure that the Sunshine Act is always the best way of doing that. And if you are asking me about the other regulatory agencies, I think that the Sunshine Act often makes, in its particular formulations, it difficult to do their job in a transparent way and in a way that is considered.

So I would be for more transparency and regularization, but maybe not quite with that particular mechanism as the tool to do it.

Mr. GARRETT. Okay. I appreciate that. And I guess the rest of the panel is, instead, open to more transparency.

Let me ask this, then. Until we get to that point, whether it is as far as I would like to go and other Members would like to go, or, as Professor Barr finds, some intermediate, is there anyone who would disagree with this statement, that until we get more transparency, more openness, and understand what the facts, analysis, and standards are, and they should cease and desist what they are doing right now? Does anybody disagree that they should be on hold until we know this?

Mr. SCALIA. I certainly agree with that prescription for two reasons: first, so that there can be a better public understanding of what the law is that they are applying; and second, because they need to look more closely at what the consequences of their designation decisions are going to be. And until we have those things, I do think it is precipitous for them to continue designations.

Mr. GARRETT. I appreciate that. And I thank the chairman.

Chairman HENSARLING. The time of the gentleman has expired.

The Chair now recognizes the gentlelady from New York, Mrs. Maloney, the ranking member of our Capital Markets Subcommittee, for 5 minutes.

Mrs. MALONEY. Thank you, Mr. Chairman, and Ranking Member Waters.

Professor Barr, I am looking at the law right now, and there is an appeals process, and an open appeals process, in Title 1 of the bill. And it says, notice and opportunity for hearing and final determination.

If I remember, we had a whole appeals process. If someone was designated, they could say, I disagree. There could be other hearings, another whole determination. And people say that the FSOC Board is not competent. It is composed of the head of the Treasury, the Federal Reserve, the OCC, the FDIC, the SEC, the CFTC, the

CFPB, the FHFA, and the NCUA, and the independent insurance expert. So, it is the basic financial regulators.

I would say we are in big trouble if our financial regulators, the head of these departments, are incompetent. That is just my statement. I think they are fully vetted and very competent.

But, in any event, they can appeal the process, and even if they are designated over their objections, there is an appeal to the courts, where everything is publicly debated, and assessments are made before a court. Is that correct?

Mr. BARR. That is correct.

Mrs. MALONEY. So I would argue there is an extensive appeal process as we see it.

Now, there has been a lot of designation, or, rather, conversation, about AIG. And AIG was an insurance company, but what designated them as an SIFI was their financial entrepreneurship, shall we say. It was not the insurance area. The insurance area was well-run, was not a problem. It was the London office where they were in all types of risky products, which brought this country to a debt of $185 billion. So, that is what designated them.

I have one question for the panel: Has any insurance company that is just totally insurance been preliminary designated or designated as an SIFI?

It is my understanding that no insurance company that is a real insurance company—if you are experimenting in financial products, then they have been designated, but not one that is a pure insurance company. Has anyone been designated that is a pure insurance company?

Mr. SCALIA. Prudential was designated essentially exclusively on the basis of its insurance activities, which drew dissents from both members of FSOC who have expert in insurance. They spoke at length about how their colleagues on FSOC appeared to have no appreciation whatsoever for the industry.

Mrs. MALONEY. Then, why was that designated and other insurance companies were not? What was Prudential doing that was different in financial areas? I would like to ask Mr. Barr, since he is a professor and not involved in the industry. I respect the industry, but I want to hear from the professor and then from you.

Mr. BARR. I don't know whether other insurance companies will or won't be designated in the future. My understanding is that the FSOC was concerned with the extent of the activity of Prudential that occurred both with respect to its investment activities and the relationship of various of its subcomponents. But I don't know whether or not the FSOC will be similarly concerned with other types of insurance firms in that regard.

And I think that you are correct to point out with respect to AIG that AIG's activities obviously extended far beyond the regular activity of an insurance firm. There were also problems within AIG with respect to securities financing among the various affiliates within AIG that created additional risk.

Mrs. MALONEY. Let's go to Prudential. Was Prudential involved in any innovative entrepreneurship financing that was different from regular insurance? No?

Mr. BARR. I have not examined with any detail for this hearing the balance-sheet and off-balance-sheet activities of Prudential.

Mrs. MALONEY. I would like to look at it and read the report and then get back with more questions.

But I also have some other questions. I wanted to ask Mr. McNabb, in your testimony you noted that under the current law, the SEC now requires, I believe, at least 83 percent or 85 percent to be liquid in their portfolios. And in your experience, during the crisis, did this remain liquid or not?

Mr. MCNABB. In our experience, it remained fully liquid.

Mrs. MALONEY. Okay. Would anybody else like to comment?

And also during the redemption period when people—there was a run really on mutual funds and everything else. During the redemption period, were they in any stress at all that you are aware of?

Mr. MCNABB. First of all, I would say there was not a run, with all due respect.

Mrs. MALONEY. Okay.

Mr. MCNABB. A run really refers—

Mrs. MALONEY. Demand, shall we say, a demand.

Mr. MCNABB. Redemptions—monthly redemptions never totaled more than roughly 2 percent of fund assets on average; even in the most extreme cases it was single digits. And again—

Mrs. MALONEY. So there wasn't a—

Mr. MCNABB. There was plenty of liquidity in the equity markets.

Mrs. MALONEY. There was no crisis.

Mr. GARRETT [presiding]. The gentlelady's time has expired.

Mrs. MALONEY. Unfortunately. This is a fascinating panel. I want to thank all of you.

Mr. GARRETT. It is.

I now yield to the gentleman from Alabama, Mr. Bachus, the chairman emeritus of the committee, for 5 minutes.

Mr. BACHUS. Thank you.

The first point Mrs. Maloney has made is that AIG—it was their counterparty risk arising from the credit default swaps, which was nothing to do with your traditional insurance business. And any argument that insurance companies ought to be regulated because of AIG just simply fails on the facts.

Insurance companies don't have the same problems with banks. Their obligations are long-term. They don't depend on short-term deposits and then lend long. So, it is just an absolute fallacy.

Mr. Barr, I remember you sitting in the conference committee where about a third of Dodd-Frank was written, sort of orchestrating the different pieces with Chairman Dodd and Chairman Frank. So I think you are probably as close as anybody to being the author of it. It probably ought to be called Dodd-Frank-Barr. So, I am not surprised—

Mr. BARR. I doubt they would agree with that.

Mr. BACHUS. I am not surprised you are here defending it.

I think Mr. McNabb makes an excellent point that I didn't know. I always learn something in these hearings that I didn't know, and that is that while the market was dropping 40, 50 percent, and people were liquidating their entire portfolios, the mutual funds only sold 6 percent of their stock. So they were really more of a stabilizing influence during the financial crisis. Thank goodness that

some of the pension funds weren't unloading, and the mutual funds weren't unloading. I can't imagine what it would have been like otherwise. And their structure, their operation, their risk profile, comparing them to a bank is—it is apples and oranges.

Is there anybody who disagrees with that, maybe other than Mr. Barr?

Mr. BARR. Let me address an aspect of that if I could, Mr. Bachus. I think that the portion of the industry that did experience a run is the money market mutual fund part of the industry. Money market mutual funds experienced quite a destabilizing run in the wake of Lehman Brothers' failure, and it was stemmed only with a $3 trillion guarantee—

Mr. BACHUS. It was less than 1 percent.

Mr. BARR. —from the Treasury Department.

Mr. BACHUS. Again, their problems were sort of—when you have a panic, there was certainly maybe a perception, but there was absolutely no reality. And I am sure a lot of people went there because they were losing money and liquidity and cash from some of the pullback in lending.

I understand what you are talking about. You are talking about maybe one money market fund, and it was less than 1 percent. You are talking about "breaking the buck." Is that what you are referring to?

Mr. BARR. I am talking about the breaking the buck and the Reserve Primary Fund, but also the run that occurred in the money market mutual fund system that was arrested—

Mr. BACHUS. Was there really a run?

Mr. BARR. —with a $3 trillion guaranteed—

Mr. BACHUS. Let me call on—

Mr. BARR. —by the Federal Government.

Mr. BACHUS. Mr. Atkins, was there a run?

Mr. ATKINS. No. Well, I just heard of that. I think the empirical evidence and studies, like one by the firm Treasury Strategies, shows that was actually not the case.

Mr. BACHUS. I just think that there is a perception, just like this perception that AIG, their insurance business; they were fully reserved, their insurance business.

Mr. BARR. I think we just have a—

Mr. BACHUS. I think we have to start with the facts, and the facts are when you are talking about a mutual fund, you are talking about a bank regulator regulating something that is not a bank in any way.

Mr. BARR. I was—I'm sorry.

Mr. BACHUS. Let me ask you this. I am a cosponsor of Mr. Luetkemeyer's bill, for two reasons. One, Mr. Scalia mentioned, that we don't know what their criteria is. It is not an open process. You don't know what to address because you don't know what—why they are deciding, which, to me, is against the whole democratic process, rule of law. You don't know what the law is—Mr. Garrett going over and not being able to even attend.

Don't you see a problem with that, that it is not open and transparent and—

Mr. BARR. I think actually having congressional involvement in the FSOC would undermine the ability of the Congress to provide

independent and effective oversight of the FSOC through forums such as this.

Mr. BACHUS. Okay. So if we understood what was going on, it would undermine our ability to have oversight?

Mr. BARR. I do.

Mr. BACHUS. Okay. That makes a lot of sense.

Thank you.

Mr. GARRETT. On that note, I yield now to the gentleman from California.

Mr. SHERMAN. Mr. Atkins, I refuse to use "sci-fi" in lieu of SIFI because I don't want to besmirch my favorite genre of fiction.

The gentlelady from New York points out that there is an appeals process, but, Mr. Scalia, I think you point out there are no standards to be applied. So if you can appeal to the Supreme Court and say, we don't meet the standard, but the standard is you are an SIFI because we say you are an SIFI, I think the Supreme Court would say, yes, you meet the standard.

But, Mr. Scalia, I think you have it wrong when you say the FSOC is the most opaque government agency in making its decisions because you are clearly not familiar with the Financial Accounting Standards Board and its process. So at most, they are in second place.

I think the FSOC got it wrong. By looking at everyone in this room, you all represent folks, with the exception of the professor, who might be designated SIFIs. The entities that were at the core of the meltdown were the credit rating agencies. They are not here because their balance sheets are in the millions, and your balance sheets are in the trillions.

But the fact is that the decisions made by the credit rating agencies, paid for by the issuers, selected by the issuers, umpire selected by one of the teams, controls far more trillions of dollars than decisions made by the witnesses in this room.

And the fact that the SEC hasn't even implemented the modest provisions of Dodd-Frank with regard to the selection of credit rating agencies makes me think I am going to be back in this room in 5 or 10 years talking about another meltdown.

The gentleman from Alabama, I think, points out that insurance companies are different. I think the proof that we had better regulation in the States than we had in Washington is that AIG was obviously run at the top by drunken sailors. They crashed on the rocks all the ships that they were allowed to control. But even under that management, all of the ships, that is to say subsidiaries, that were subject to State insurance regulations survived and have even provided sufficient profits to resurrect the fleet.

The problem, therefore, is not in the States, it is here in Washington, where we prohibit calling a credit default swap insurance, which is, of course, crazy. If I ran a fire insurance company and said, I am unregulated; if your house burns down, I won't give you a check, I will give you a U.S. bond; you can trade your house, your burnt-down house for a U.S. bond, that would be an end run around, say, fire insurance regulation, and we wouldn't allow it. But instead, we have this bizarre notion that if we insure your portfolio, that is insurance, but if you can trade your burned-down portfolio for U.S. bonds, that is not insurance.

And so Congress allowed AIG and continues to allow these unregulated insurance policies on portfolios to be issued without any insurance regulation.

Finally, I will point out that too-big-to-fail is too-big-to-exist. It shouldn't be just a matter that these entities are so large that we will give them special regulation, and then they will save 80 basis points on their cost of funds.

Mr. McNabb, you have all my money. You may not know this. The only way you are an SIFI in the sense that you could take an action that could cost Americans trillions of dollars would be if the money you say you are holding for me isn't in your vault.

I am responsible for the investment decisions. Putting aside all the things you do voluntarily, and all the things you do as part of industry, and looking only at the requirements imposed by government, what requirements are there so that I know that the value of the assets in your vault is equal to all the statements you have mailed out to everybody in the country?

Mr. MCNABB. First of all, thank you, sir, for being an investor. I am very grateful for that.

Mr. SHERMAN. Thanks for the low fees.

Mr. MCNABB. We are endeavoring to keep them as low as possible.

The structure of mutual funds is very different—this is the big difference between funds and a bank-like organization. Each fund is a separate entity and is separately managed, has a separate board of directors, and the assets are custodied separately. So actually, there is no Vanguard vault where your assets reside; they are held by a separate custodian. And funds cannot be commingled.

So, let us use the S&P 500 Fund as an example. If Vanguard—

Mr. SHERMAN. You picked the one that has all my money.

Mr. MCNABB. If Vanguard went out of business tomorrow, then the fund's board would simply arrange another advisory agreement with another firm to manage these assets. Those assets would be separate and whole. Different funds also cannot commingle assets. So one fund being down can't borrow from another fund in order to "make it whole." Each fund has to be treated as a separate entity.

And again, this goes to the whole nature of the difference between funds and banks. We are acting as agents. You are an equity holder in a fund, and we are acting on your behalf, whereas a bank is a proprietary institution.

Chairman HENSARLING. The time of the gentleman has expired, but the Chair found the answer interesting.

The Chair now recognizes the gentleman from Texas, Mr. Neugebauer, the chairman of our Housing and Insurance Subcommittee, for 5 minutes.

Mr. NEUGEBAUER. Thank you, Mr. Chairman.

The identification of a nonbank systemically important firm is a fairly serious exercise. And I think it has a lot of implications for the competitiveness of some of those firms. It says to the world that this institution has systemic risk to the financial markets.

It has been discussed that recently Prudential was found to be one of these SIFIs. And it was interesting, and I think it has been brought out in testimony, that several of the people who sit on

FSOC, either in an advisory capacity or a voting capacity, didn't agree with that decision. In fact, John Huff said that FSOC's misguided overreliance on banking concepts is no more apparent than FSOC's basis for the designation of Prudential Financial. He went on to say that the basis for that designation was grounded in implausible, even absurd scenarios.

Mr. Scalia, what were your views on FSOC's mythology and their final decision?

Mr. SCALIA. The Prudential decision is an unusually thinly reasoned and poorly substantiated decision for a government agency in several ways. As you note, the members of FSOC who had the expertise in insurance were very troubled by the analysis or lack thereof.

Mr. Wallison talked about the coordinating function of FSOC. We have talked about the expertise of FSOC. Those can be valuable things, but if those members of FSOC who have the expertise in that specific industry are deeply troubled and ignored, that is going to yield a very poor government decision, which is exactly what happened there. So I don't think that FSOC—to the extent it has expertise—functioned properly in that case.

Mr. NEUGEBAUER. There has been a lot of discussion about what does that mean, and what does that mean to that company. What would you see some of the consequences that a firm might experience, and its customers, for being designated as an SIFI?

Mr. SCALIA. The consequence of SIFI designation that is, I think, most apparent is being subjected to different capital requirements. And we currently, under Dodd-Frank as written and as interpreted by the Fed, have every reason to believe that a designated company will be held to the capital requirements applied to a bank, which is remarkable, because I think there is unanimity that bank-based capital standards are really inappropriate for other kinds of financial institutions.

I think what is transpiring is that FSOC is taking the position, "We don't make the capital standards decision, the Fed does;" and the Fed says, "We don't make the designation decision, really, FSOC does." And so, you have designation with consequences that everybody recognizes are quite problematic, but the answer seems to be, that is okay because the left hand doesn't know what the right hand is doing, which is not ordinarily how the government ought to defend its actions, particularly when you have this body, FSOC, which is supposed to be coordinating and ensuring consistent intelligence in how regulatory matters are approached.

Mr. NEUGEBAUER. Thank you.

Mr. Wallison, you described FSOC's designation of Prudential as perfunctory and data-free, I believe. In fact, you said that the only useful numbers in its designation were the page numbers.

So should the FSOC's designation process be more rigorous or more transparent, or what would you think is a more appropriate process for FSOC to go through for these designations?

Mr. WALLISON. I think we have to recognize from the beginning that what they are doing is very serious for the firms involved, and serious, actually, for the economy as a whole. And so we would expect that when they make a designation, they would actually be

able to show us, especially show Congress, what it was they based the designation on.

I also said in my remarks that the FSOC used the word "significant" 47 times in a 12-page paper, which was their entire justification for designating Prudential as an SIFI. This is not adequate. And one of the reasons I said that they seemed to be an emperor without any clothes is that I went back and looked at what they did for the other previous designees, AIG and for GE Capital. Same thing. No specifics.

So I have the idea—and I would like to see it disproved—that they have no way of demonstrating the things that they are required to demonstrate, which is that a firm's financial difficulties would lead to instability in the U.S. economy. And if they have no way of demonstrating that, they shouldn't be allowed to make these decisions arbitrarily.

Mr. NEUGEBAUER. Thank you. My time has expired.

Chairman HENSARLING. The time of the gentleman has expired.

The Chair now recognizes the gentleman from Texas, Mr. Hinojosa, for 5 minutes.

Mr. HINOJOSA. Thank you, Mr. Chairman.

Before the financial crisis, the financial regulators focused on different segments of the market, which caused a fragmented approach to oversight. There was no organization tasked with taking an eagle's-eye view of the entire financial system to watch for impending trouble.

The Financial Stability Oversight Council was created to do just that. Had there been a council in place, it is possible they might have identified the systemic risk infecting the economy and could have diverted the crisis.

The Financial Stability Oversight Council is the cornerstone of the Dodd-Frank Act. Let us not forget the cost of the disjointed approach to financial regulation prior to that crisis. The Government Accountability Office estimates that the 2008 financial crisis cost the U.S. economy more than $22 trillion. Whereas today's hearing supposedly seeks to examine the dangers of the FSOC's designation process, the real danger to the American economy arises when our regulators are asleep at the switch.

As the Financial Stability Oversight Council proceeds with identifying systemically important institutions, Congress should seek to improve its effectiveness, not hinder it.

Some criticize that the FSOC's designation process has been opaque. My first question is to Mr. Barr. Do you have any suggestions for increasing transparency in this process?

Mr. BARR. I think that you are correct that the FSOC designation process is essential to policing the boundaries of systemically important financial institutions and ensuring that there is a safe system in place.

There are undoubtedly ways that the process, which is a quite new process, can be made more standardized and more transparent over time. I think that the FSOC has done a good job, given the new nature of the proceedings, to get started. There may be ways of providing more information in advance to firms that are more specific about the types of showings that will be required. As it currently exists, a lot of that information is provided to firms during

the process of the—the provisional designation, and it may be possible over time to move that data and information up further in the process.

Mr. HINOJOSA. Mr. Barr, is the FSOC appropriately balancing the need for transparency against the need to protect sensitive market and supervisory information?

Mr. BARR. I think the balance they have struck so far is a reasonable one. It is not the only one you could strike, but I think that it is a reasonable one. And I think that firms have a great deal of time to participate in the process, the ability to provide essential information to the FSOC that is necessary for a designation.

Again, I think over time it may be that the FSOC, after reviewing its experience over the initial period, may move the process one way or another along the lines of providing greater transparency, but I think the path they have chosen thus far is a reasonable one, given the newness of the process.

Mr. HINOJOSA. Lastly, Mr. Barr, do you agree that the FSOC has both the expertise and the authority to appropriately assess the nonbanking financial institutions, such as insurance companies?

Mr. BARR. I do. It certainly has the expertise and the authority to act in these areas based on not only its own staff, but the staff of its member agencies. As with any organization, I think that it is going to continue to want to build the expertise, the in-house capacity, the data analytics, the data collection that is necessary to be effective, but I think they are doing a good job so far.

Mr. HINOJOSA. I yield back, Mr. Chairman.

Chairman HENSARLING. The Chair now recognizes the gentlelady from West Virginia, Mrs. Capito, the chairwoman of our Financial Institutions Subcommittee, for 5 minutes.

Mrs. CAPITO. Thank you, Mr. Chairman. And I apologize for having to step out of the hearing during your statement. I just have a couple of questions.

One question I wanted to ask was alluded to in my opening statement, and that is the $50 billion threshold for automatic SIFI designation for banks. As you know, there has been a lot of discussion as to whether that is an arbitrary deadline—arbitrary designation threshold. And I guess I would like to ask each of you to answer the question.

There have been a lot of folks who have said that we need a more nuanced approach where we are looking more at the risk profiles and deeper into each institution's business models as opposed to just using a specific $50 billion as a threshold. So I am just going to go down the line and ask each of you if you have an opinion on that, and I will start with Mr. Atkins.

Mr. ATKINS. Thank you.

I think that to have an arbitrary type of threshold like that does not make a lot of sense. But I think, to what is being discussed here, if you look at what even President Obama's designee on the FSOC said about the whole process with respect to Prudential, he criticized and said it was not reasonable, not supportable, no data was run. So even the President's own insurance designee had that to say about the flow of process.

Mrs. CAPITO. Okay. Mr. McNabb?

Mr. MCNABB. Again, the asset level makes no sense to me either, neither for banks nor for investment companies.

I would say any focus that the FSOC should have should be on activities as opposed to institutions or asset levels.

Mrs. CAPITO. Is there a feeling that the threshold is too low? It should go to $100 billion, or just an arbitrary threshold is—

Mr. MCNABB. I think just arbitrary.

Mrs. CAPITO. Okay. Mr. Scalia?

Mr. SCALIA. My principal concern with the threshold is that there is no evidence that there is anything beyond that threshold that is being considered and resulting in designation. It appears to be the case, for example, when you read the Prudential decision that once you hit the threshold, the agency will simply engage in a series of speculative hypotheses and designate you.

Mr. Wallison has pointed out that the sort of undefined word "significant" appears 47 times. There is actually a word that appears almost twice as much. In this 12-page decision, the word "could" is used 87 times. The words "would" or "will," which constitute findings, scarcely appear at all. So there is this very speculative approach once you hit that threshold.

Mrs. CAPITO. Mr. Barr?

Mr. BARR. I think the key question is, the key point is to make sure that the approach that is taken to firms is a graduated approach and a nuanced approach that is consistent with not just their size, but their risk profiles. So I don't think there is an on/off switch. If you are a $50 billion plain vanilla bank, you need a much lighter touch form of oversight than if you are a complicated institution. And I think having nuance and graduated approaches that are tailored to the risks that firms do or don't pose is the essential thing.

Mrs. CAPITO. Right. But that doesn't exist presently. It is just a threshold and on type of approach, correct?

Mr. BARR. In the current structure, it is not just an on/off switch; there is a graduated approach to regulation. I think that the—the point would be making sure that it is graduated enough and nuanced enough. It is not an on/off switch now. There are higher, more intrusive forms of regulation, of supervision, of capital requirements, of stress testing, of resolution planning that are more stringent at much higher levels of asset size—

Mrs. CAPITO. Right.

Mr. BARR. —than they are for a smaller firm. I think that is good and appropriate. And the question is, I think, can you just make that even more of a graduated nuanced approach? I think there is room to do that.

Mrs. CAPITO. Okay. Mr. Smithy?

Mr. SMITHY. Thank you.

So as we stated in our written testimony, we do believe an arbitrary asset size threshold is inappropriate, as we stated. Our business models are very straightforward. We are simple. We take deposits and make loans. We are not engaged in the range of activities that would lead to a situation where it threatens the U.S. financial system, and so we do believe the arbitrary nature of that threshold is inappropriate. We think a more activity-based ap-

proach would give regulators the flexibility to tailor regulation to the risks inherent in each firm.

Mrs. CAPITO. Thank you.

Mr. Wallison?

Mr. WALLISON. If regulators on the FSOC are able to designate nonbank financial institutions as SIFIs, then they ought to be able to do exactly the same thing for banks, and that is not what they are told to do. They have been told to choose an arbitrary number.

I might mention that the International Association of Insurance Supervisors made up a methodology for how you judge the riskiness of an insurance company, and they provided that to the FSB, which apparently was never used. But, in any event, what it said is that size is about 5 percent of the question. There are other, much more important questions that don't have anything to do with size.

Mrs. CAPITO. Thank you. I think my time just expired. Excuse me.

Chairman HENSARLING. The time of the gentlelady has expired.

The Chair now recognizes the gentleman from Massachusetts, Mr. Lynch, for 5 minutes.

Mr. LYNCH. Thank you, Mr. Chairman.

Mr. Chairman, I just have a couple of procedural things. I have here a letter from Damon Silvers, he is the policy director and special counsel for the AFL-CIO; a letter from the Americans for Financial Reform; and a white paper by Douglas J. Elliott, a fellow at the Brookings Institution, assisted by William Becker. The title of it is, "Systemic Risk and the Asset Management Industry." I would like to have those entered into the record.

Chairman HENSARLING. Without objection, it is so ordered.

Mr. LYNCH. This piece by Douglas Elliott is particularly good. I don't necessarily agree with all of it, but I think it serves the purposes of what we are talking about here today.

I think it is an easy question. I want to thank the witnesses. It has been a very helpful discussion.

The easy case, I think, is the case of a garden-variety mutual fund. I think there are a lot of aspects that you have all pointed out that acquit the idea of SIFI designation for mutual funds. The revenue stream is fairly stable, they get their money from fees, very low use of leverage, much smaller balance sheets than what we are generally concerned about, very little debt. The share price is published and recalculated each day, and shareholders are free to redeem their shares every day.

And, best of all, mutual funds have really allowed average families, average working families, to assemble wealth. It has been an enormous benefit to a lot of American families, and it would be—as Mr. Elliott points out in his paper—a shame if we were to regulate these funds in such a way that destroyed that opportunity for a lot of hard-working families.

The tougher question really, and I think, Mr. Barr, you have tried to address this on a couple of occasions, is the question of hedge funds that operate more like banks and that, quite differently, have no limits on leverage. They are not subject to any of the regulations that registered funds are subject to. They can impose very onerous redemption restrictions on investors, and they

are exempt from many of the oversight and reporting requirements we have on other funds.

In the other case is money market funds that operate in the repo market, and you started to talk about that earlier with the gentleman from Alabama. And those are the tougher questions, because those are examples of the problems that we are trying to get at, but they are "asset managers."

So, Mr. Barr, how would you get at the risks that these—look, some hedge funds don't operate high leverage, but a lot of them do, and there is no limit on the investment strategies that they adopt. They are sort of out there, and we don't know a heck of a lot about them until something goes wrong.

How would you address the situation with these hedge funds and with the money market funds that operate in the repo market that we saw runs on previously?

Mr. BARR. With respect to money market mutual funds, I am in favor of the SEC using its existing authority to remove the regulatory provisions that permit funds to carry a stable net asset value unless they have capital that deals with the run risk from such a fund. I think that having that option is the preferred policy approach.

With respect to hedge funds, the Dodd-Frank Act gave the SEC the authority to collect information with respect to hedge funds, and obviously the FSOC and the OFR also have such authority. And I think having that information on such funds is the primary way of understanding what is going on in that marketplace.

If a hedge fund was sufficiently systemically important, the FSOC also has the ability to designate such a firm and to subject such a firm to supervision and capital requirements. In the absence of such a finding, most hedge funds, even highly leveraged ones, can operate and disappear without anyone worrying about it.

Mr. LYNCH. Yes. What about the money market operating in the repo market where we have had runs before?

Mr. BARR. I think that repo market reform directly is probably the most efficient way of getting at that. I think there is much work that can still be done to reduce risk in the triparty market in particular, and the Fed has existing authority to do that.

Mr. LYNCH. Thank you. I yield back the balance of my time.

Chairman HENSARLING. The Chair now recognizes the gentleman from North Carolina, Mr. McHenry, chairman of our Oversight and Investigations Subcommittee, for 5 minutes.

Mr. MCHENRY. Thank you, Mr. Chairman.

Mr. Barr, you said the OFR's asset management report is not something you would hang your hat on—I think that is what you said a little bit earlier. And I think that is interesting, because the FSOC directed the Office of Financial Research to issue the report, to undertake this. So, this was a directive of the FSOC. And it is interesting because OFR has functioned, as you well know, as basically, a vassal of the Treasury Department, or contained within it and the reporting structure.

So, do you think that the research would be better done by independent agencies?

Mr. BARR. The OFR can and does have independent authority within the Treasury Department, akin to the kind of independence

that the OCC has within the Treasury Department. And I think that it, from at least all intents and purposes, was working with that independence in mind.

Do I also think that it would be good for other agencies to look at the sector? Yes, I do. I think there is expertise in other member agencies and the FSOC staff at the SEC and otherwise, and that is healthy for the system.

Mr. MCHENRY. To that end, at the SEC, they put up this report for notice and comment. Do you think that was positive?

Mr. BARR. I do. I think that was a very healthy move by the SEC, as they have done with the money market mutual fund report and other efforts.

Mr. MCHENRY. Sure.

But the notice-and-comment part of this is not a requirement of the FSOC; is that correct?

Mr. BARR. There is a formal process with respect to designation. The issuance of a report—

Mr. MCHENRY. But they have to follow the Administrative Procedures Act.

Mr. BARR. The issuance of a report by any government agency does not usually require, just for the issuance of the report, a notice-and-comment process. I think it is a healthy and useful thing for agencies to do, to put out draft reports and to get comments on it.

Mr. MCHENRY. Do you think FSOC should be under the Administrative Procedures Act?

Mr. BARR. It is governed by the Administrative Procedures Act with respect to its work.

Mr. MCHENRY. Should the OFR?

Mr. BARR. It is already under the Administrative Procedures Act, but, again, normally the issuance of a report is not the kind of regulatory step that would require a formal process. I think it is healthy and good for regulators for all government agencies when they are issuing a report do so.

Mr. MCHENRY. I appreciate it. Thanks.

Mr. McNabb, when the Financial Stability Board has already decided that asset managers are systemically important, so it seems like the FSOC's designation, because we just assume they are going to go forward with this designation of asset managers, it is sort of mindlessly following the FSB on this.

So what I don't understand is asset managers being not—they are not leveraged, so how do higher capital standards actually—how does that actually make sense? Higher capital standards would have absolutely no impact on an asset manager's ability to run its funds.

Mr. MCHENRY. So to actually put bank-like regulations, capital requirements is completely unfitting with what asset managers do. Is that right?

Mr. MCNABB. That is correct, sir.

Mr. MCHENRY. Okay.

Mr. Wallison, you wrote that the designation process will result in one of two things, and let me quote you: "Either we will have large, successful, government-backed firms that swallow up smaller competitors or we will have large, unprofitable, heavily-regulated

giants that are gradually driven to failure by their more nimble and less-regulated competitors. In the former case, small firms are the victims and in the latter case taxpayers will pay for the bail-outs.”

So, designation must be the proverbial ill wind that blows no good. Would you concur?

Mr. WALLISON. It looks that way to me because I was talking there about the question of too-big-to-fail, and many people have said, including the former chairman of this committee, that, well, why is everyone opposing becoming an SIFI if, in fact, it is a benefit if you are too-big-to-fail? And the answer is that nobody really knows what the consequences will be. There may be benefits in the financing that you get, but there may be detriments in the cost of the regulation you have to suffer.

And the point I was trying to make in the paragraph that you read is either way, as a public policy matter, it is a bad idea, because either we have firms that are benefited and outcompete those that are not designated as SIFIs or, in the other way, they are hurt by excessive regulation, and as a result they fail and the taxpayers have to come in and bail them out.

Chairman HENSARLING. The time of the gentleman has expired.

The Chair now recognizes the gentleman from Georgia, Mr. Scott, for 5 minutes.

Mr. SCOTT. Thank you very much, Mr. Chairman.

First, Mr. William McNabb, let me welcome you to the committee. You are a graduate of the Wharton School of Finance at the University of Pennsylvania, the absolute greatest school of finance and business in the world. Of course, I am graduated from there, and I got my MBA there as well. And we both spent a lot of tough times in Lippincott Library and Dietrich Hall. Welcome.

Mr. MCNABB. Thank you.

Mr. SCOTT. Let me just ask you this: How do you rank the basic general risk in the market now?

Mr. MCNABB. Could you be a little bit more specific? Equity markets or the bond markets or—

Mr. SCOTT. As we look at this, in either market, what do you see as our greatest challenges as far as risk in the market today, whether it is the bond market—maybe the bond market. I will wait for you to assume which of the markets has the greatest risk. But I think it would be helpful to this committee if you could tell us what you see as the top three threats, risks to the market.

Mr. MCNABB. The largest threat I see to the markets is one that actually hasn’t been talked about in any of the discussions, and it is the cyber risk that exists out there. And it is more than just a financial institution risk, it is really a risk to all businesses. When you look at what has happened in the last 18 months where nation-states are getting way more involved in this, that trumps almost anything I have seen in my career.

Mr. SCOTT. Good.

While I have the time, I also want to go to you, Mr. Smithy. You referenced Governor Tarullo’s speech on prudential regulation in your comments. Why do you think that he seems willing to reconsider some of the existing asset thresholds from regulatory supervision?

Mr. SMITHY. Thank you. Based on my read of his speech, I think he thinks an arbitrary asset threshold is imprecise in its nature, and he is in favor of more tailored solutions reflecting the differences among firms, and he is in favor of regulation that is commensurate with the risk of each of these firms. And in his comments, I think he believes that an asset-only threshold only subjects firms that do not engage in risky activities to the added burden of regulation.

Mr. SCOTT. Now, correct me if I am wrong, but is it not true that regional banks hold one-fourth of the Nation's total bank deposits? Is that an accurate statement?

Mr. SMITHY. The 18 banks in the Regional Bank Coalition do hold one-fourth of the Nation's deposits, yes.

Mr. SCOTT. And let me ask you what your greatest concerns are, given the status of the regional banks, as opposed to our much larger banks in relationship to this asset threshold supervision.

Mr. SMITHY. The cost burden is both direct and indirect. For Regions Bank, which I can speak to specifically, the cost of compliance and regulation has more than doubled over the last 5 years. It is the largest single increasing cost in our operating structure. There are many elements to it that seem unnecessary, given the activities that we are engaged in. A point I would give you is we now have more folks in compliance activities than we do in commercial lending, than commercial lenders at our bank. So, again, I think that speaks to the direct costs of compliance.

There are also indirect costs, which are management and board's time and attention focusing on compliance matters and away from serving the needs of our communities and our customers.

Mr. SCOTT. And if I am also clear, regional banks, unlike other size banks, probably do more of asset building and lending to small businesses as a percentage of what you do. Is that correct?

Mr. SMITHY. That is correct. We serve a lot of smaller and medium-sized markets, much like the community banks. The larger banks, the more internationally active banks tend to focus on larger organizations. So we are an important source of credit for small and medium-sized firms in smaller and medium-sized markets.

Mr. SCOTT. So this asset threshold regulatory supervision issue that you are talking about would have a negative impact on your ability to assist small businesses?

It looks like my time is up on that, and the chairman has done it twice. So I take the message.

Mr. LUETKEMEYER [presiding]. Thank you.

With that, the gentleman from California, Mr. Royce, the chairman of the House Foreign Affairs Committee, is recognized for 5 minutes.

Mr. ROYCE. Thank you, Mr. Chairman.

I have a question for Mr. Wallison and Mr. McNabb, and I have a question about the now infamous OFR asset management report, a report that even Michael Masters' Better Markets shop called inexplicably and indefensibly poor quality, and today a report that Professor Barr said he would not hang his hat on. And so, as has been referenced, the SEC opened the OFR's report for comment, which gave the public the opportunity to directly point out the flaws and poor analysis in the report. I think this simple but im-

portant step by the SEC has raised some serious questions about whether the OFR should be required to follow the same notice-and-comment procedures as financial regulatory agencies.

As it relates to reports, is there any good public policy reason to exempt the OFR from providing public notice and comment as the American people expect from other regulators in a system that we are trying to run here that is transparent and open? And is there any good public policy reason to exempt the OFR from consulting with and incorporating changes proposed by prudential regulators, proposed by the safety and soundness regulators? And would you support congressional action to mandate this openness and inclusion of outside expertise?

Mr. Wallison?

Mr. WALLISON. Yes, I think it makes all kinds of sense for these organizations like OFR to make their reports public. The public is paying for those reports, and the other agencies are relying on those reports. It is essential that people know what is in the reports that institutions, agencies are relying on, and the quality of those reports. If the SEC had not put out this report for comment, no one would have realized what a poor quality piece of work it was. The likelihood is the FSOC would have relied on it, might have even stated they were relying on it, and no one would have known that it provided no substantial guidance. So I certainly agree that, with your legislation, that is what should be required.

Mr. ROYCE. Thank you, Mr. Wallison.

Mr. McNabb?

Mr. MCNABB. I would agree with Mr. Wallison. When you look at the consequences of a report like this and the amount of activity that has been created since its release, I think it goes without saying that it should be available to the public and should be available for comment. I think the SEC comment period offered an opportunity for many people who really understand these issues pretty deeply to point out some of the data inaccuracies and the flaws in the report.

Mr. ROYCE. The other aspect of my question was, in terms of the functional regulators, what about the concept of having the OFR, currently exempted from consulting with, what about a mandate for a consultation there where you allow an incorporation of the changes of those who have the responsibility to look at such issues as prudential regulation and so forth?

Mr. MCNABB. That would make sense to me in that it would lead to a better outcome, a better, more accurate report.

Mr. ROYCE. Thank you.

And I was going to ask Mr. Atkins, this issue was raised previously, but not to you directly. So when we are talking about SIFI designation, or as you have termed it "sci-fi" designation, and we look at that designation of asset managers, what we are really talking about is something here that lends to the destruction of wealth because of the costs involved. Because of the regulatory burden, the compliance costs that come with it, it is a destruction of wealth, but it is not Wall Street's wealth here. If you think it through, it is wealth held by average Americans, those saving for retirement, those saving for a downpayment, those saving for college tuition.

They are going to have a lower return on their investment because of the higher costs.

And it is not really justified by a risk in the market, given that the asset managers themselves are controlling or are handling accounts by individuals. Can you explain more clearly why designating asset managers as SIFIs would harm average investors? Do you want to walk through that argument?

Mr. ATKINS. Thanks for that question. Like you are saying, being designated as an SIFI is not just joining a club or some exclusive club. There are consequences to it, and that is the imposition potentially of a bank capital type of regulatory structure. And like we were saying with asset managers, it is ultimately the investors who bear the burden because, as Mr. McNabb was saying, it is investors' capital, it is 100 percent capital in most cases in mutual funds, it is either on them or on the asset manager. And so it is all inapposite.

Mr. ROYCE. Thank you, Mr. Atkins.

Thank you.

Mr. LUETKEMEYER. Thank you.

With that, we will go to Mr. Meeks for 5 minutes, the gentleman from New York.

Mr. MEEKS. Thank you, Mr. Chairman.

Let me just say this first because sometimes I think we forget how we got here in the first place. We created FSOC because it was quite evident that we needed an interagency process to better understand the very complex multisector and multimarket nature of systemically important financial institutions and companies, and to adopt a stronger microprudential approach to financial supervision. And the Financial Stability Board was created to address the lack of coordination of these issues at the global level, as these very large institutions and companies act on a global scale, with global interconnectedness and risk exposures.

Furthermore, FSB was meant to deal with harmonization of financial regulations across the global financial markets, and I have often talked about how vital harmonization of rules to ensuring that American banks and companies can compete on a level playing field. This is vital to our economic interests and job creation here in America.

And I know that sometimes I have raised concerns also about heightened supervision of insurance companies by the Federal Reserve and the risk of applying banking standards to an industry that operates a completely different business model. But that is not a valid reason to undermine the FSOC designation process, and designation is separate and different from supervision and rulemaking.

So my question goes first to Mr. Wallison. Do you think it is wrong for domestic authorities to come together on an international level and cooperate with one another as the FSB and G-20 are demonstrating currently?

Mr. WALLISON. I don't think it is wrong at all. I think those kinds of consultations should occur all the time, it is very important. It is important here in this country and it is important internationally. The only question is whether these international bodies should take positions that have an effect on our domestic economy,

and I am afraid that the positions that they are talking about will have very adverse effects on our economy.

Mr. MEEKS. Then, would you not say that FSB and the G-20 are playing significant and important roles in terms of seeking the global cooperation and harmonization on financial markets and international banking rules?

Mr. WALLISON. That isn't my understanding of what the G-20 told the FSB to do. It wasn't just harmonization. They told them to develop reforms to the international system to avoid the next financial crisis. And the FSB has taken that baton and run with it to attempt to designate individual companies that ought to be regulated specially in order to achieve that goal.

That isn't the only way to achieve that particular goal. It is the regulators' way of achieving that goal, and that is to get hold of companies and tighten the regulations on them. That isn't necessarily the way that you would ordinarily do it if you were asked to attempt to prevent the next financial crisis. That is, however, how the FSB interpreted the G-20's instructions.

Mr. MEEKS. Mr. Barr, let me ask you the same two questions. How would you respond?

Mr. BARR. I think the role of the G-20 and the Financial Stability Board are absolutely critical in not only harmonizing, but also raising standards internationally, and that is helping to make the U.S. financial system and the global financial system safer. I think that there are probably initiatives that the FSB could take to make its own process more transparent and more regularized that would be helpful.

And I should just point out, as I did in my testimony, that the actions that are taken by the G-20 and the FSB are not binding on the United States. The United States makes independent judgments about how to and whether to adopt or adapt international rules, international standards, international designations in the domestic context. And you have seen already lots of examples where the United States has chosen to take a somewhat different course from the international standard-setting bodies, and you see other countries around the world doing that, too, the U.K., Switzerland, and the like.

So there is flexibility to approach the domestic regulatory questions independently and in light of our own domestic judgments about risk.

Mr. MEEKS. I would ask another question, but I only have 15 seconds, and the chairman has a quick hand with that hammer, so I guess I will just yield back the balance of my time.

Mr. LUETKEMEYER. I thank the gentleman. I don't think it is that quick. We had a little leeway here with a couple of them. But, thank you.

With that, the chairman grants himself 5 minutes for questions. My first comment is to Mr. Atkins.

I understand your concern with "sci-fi" and SIFI, Mr. Atkins. I come from "Missouree" or "Missouruh," nobody knows for sure, so I understand your concern.

But thank you all for being here today. It is an interesting discussion. As Mr. Smithy indicated, I have a bill that tries to address some of this, as far as the banking institutions anyway.

And with that, Mr. Smithy, I have a couple of questions for you. I have here in front of me a chart that actually lists one bank, JPMorgan, and then the next 14, the largest 14 regional banks in size, they only make up as much as what JPMorgan is. And I think this gives you an idea of the relationship and size with regards to the different entities we are talking about. It puts things in perspective.

When you are looking at derivative contracts, the top 4 bank holding companies have 76 percent trading assets, 84 percent of the total market, credit default exposure 94 percent, whenever these regional banks have less than 1 or 2 percent of all that. So I think we are looking not only at size, but you are also looking at the size of the risk, the risky activities they are engaged in, and it would seem to me that it would flow that FSOC would take a rather positive view of this.

However, that being said, it seems that they have a different idea. And I would just like your comment with regards to that, Mr. Smithy, with regards to how you view, after seeing these statistics and your position on this, where we are at with FSOC.

Mr. SMITHY. Sir, obviously we do not go through that process currently. We are deemed an SIFI based on asset size alone, which is at the heart of the issue for us. As you point out in that chart, we are traditional lenders. Our sizes in aggregate only rank as large as the largest U.S. bank. But I think more than that, it is the range of activities within which we are engaged. We don't have the complex legal structures that are difficult to resolve in a crisis, we do not engage in securities market making, we are not in trading activities. We are simply traditional lenders.

We are simply asking for due process similar to what the nonbanks would go through in determining whether or not the range of activities within which we are engaged would deem us systemic, and that is what we would expect, that the FSOC would put us through a similar process as they do the nonbanks.

Mr. LUETKEMEYER. Mr. Wallison, I have been in a meeting where you were engaged in discussing this subject as well, and you seem to have a similar opinion to what Mr. Smithy does of institutions. You base it on risk, connectivity, not just asset size.

Mr. WALLISON. Yes, especially for banks, as I said before. If the FSOC is really able to designate nonbanks as SIFIs, then certainly for banks, they could do the same thing. And so we shouldn't actually set any kind of arbitrary size for these institutions but rather look at their activities and determine whether they could cause an instability in the financial markets if they ran into some sort of financial difficulty.

Mr. LUETKEMEYER. It is kind of interesting—the gentlelady from New York made a comment a while ago about all the experts on FSOC, yet whenever FSOC made its SIFI designation to Prudential, it disregarded all the insurance experts on the committee. I wonder why? Interesting. It would seem to me that maybe they are trying to justify their existence by doing something rather than allowing the actual existence of facts and data to drive their decisions versus trying to justify their existence.

Mr. Scalia, you had made some interesting comments during the course of your commentary. I jotted down in my notes that you

made some comments with regards to how most of the decisions of FSOC couldn't pass legal muster from the standpoint that they don't justify what they are doing, there is no transparency, and if you ask them how they could come up with this decision, there isn't a logical or reasoned way to do it that could actually, if this was taken to court, pass muster. Would you agree with that comment of mine or my assessment of your comments?

Mr. SCALIA. That is accurate. Actually, it was the ranking member who said that what we should expect from an SIFI designation is a strong analytical basis, and I think we all agree, and that is what is so sorely absent. The Prudential decision, for example, it is meant to be a risk assessment, right? We are doing a risk assessment. Well, a risk assessment considers the probability of the event and the magnitude, and neither of those things is determined or even estimated in the decisions that have been issued so far by FSOC.

Mr. LUETKEMEYER. Okay. Thank you.

With that, I will turn next to the gentleman from Texas, Mr. Green.

Mr. GREEN. Thank you, Mr. Chairman. I thank the ranking member as well, and I thank the witnesses for appearing.

If you are of the opinion that there should not be an FSOC, would you kindly extend a hand so that I may identify you. I think the record should reflect that Mr. William—is that correct?

Mr. WALLISON. Wallison.

Mr. GREEN. Wallison, excuse me, my vision is poor, and the distance is quite a ways from me. And who is the other person? Would you speak your name again?

Mr. ATKINS. Paul Atkins.

Mr. GREEN. Mr. Atkins. The two of you are of the opinion there should be no FSOC at all?

Mr. ATKINS. As currently constituted, right.

Mr. GREEN. Thank you. And let's go into some other areas now. Do you agree that Prudential was a $1 trillion company in terms of assets, above a trillion? Or is?

Mr. WALLISON. If you are asking me, I don't know the exact number, but I will accept a trillion.

Mr. GREEN. It wouldn't surprise you to know that it was a trillion?

Mr. WALLISON. No.

Mr. GREEN. Okay.

And let's go to Mr. Barr. Mr. Barr, this company, Prudential, had the right to appeal. Is this correct?

Mr. BARR. Yes.

Mr. GREEN. And this is in a Federal court. Is this correct?

Mr. BARR. Yes.

Mr. GREEN. And would you just briefly outline the process that allows a Prudential or any company similarly situated to appeal?

Mr. BARR. There is a process that is set out by the statute and by the FSOC internal rules and guidance that describes three stages of review—a first stage review, a second stage review, and a third stage review—that ultimately could lead to a provisional determination and a final determination. At the conclusion of a final determination, the affected company has a right to seek re-

view in Federal court of that final determination to assess whether that determination meets the legal requirements for a designation.

Mr. GREEN. Is it fair to say that Prudential, a $1 trillion corporation, has some pretty good lawyers? Is that a fair guess?

Mr. BARR. I actually don't know their legal counsel at all.

Mr. GREEN. Would you just guess that a $1 trillion corporation has some pretty good lawyers?

Mr. BARR. I have seen terrific lawyering and bad lawyering at all levels of our economy.

Mr. GREEN. I will speak for you. With a trillion dollars, my suspicion is that they can afford some pretty good lawyers.

Mr. BARR. I would agree with that statement.

Mr. GREEN. All right, they can afford pretty good lawyers. Is it true that they did not appeal?

Mr. BARR. It is true.

Mr. GREEN. Is it true that they had the right to appeal?

Mr. BARR. Yes.

Mr. GREEN. If they did not appeal, is it also correct that perhaps they concluded that there was good reason to stay within the system and to abide by the rules and regulations imposed upon it?

Mr. BARR. I am not privy to their internal deliberations, and often firms have a complex range of reasons for taking or not taking legal action. So I would rather not opine on what they were thinking.

Mr. GREEN. Is it true that some of your colleagues have opined and concluded that they were not treated fairly?

Mr. BARR. I'm sorry, I don't—

Mr. GREEN. Some of your colleagues on the panel—

Mr. BARR. Oh.

Mr. GREEN. —have concluded that they have not been treated fairly?

Mr. BARR. I should maybe let them speak for themselves about that. I understood them to be critical of the FSOC process.

Mr. GREEN. The process. If the process is in some way flawed, would not appeal be a means by which—or if the decision is one that you believe to be inappropriate or unfair, would appeal be an appropriate remedy for you?

Mr. BARR. I think that a Federal district court is, generally speaking, a pretty tough and good place to go seek redress if legal procedures have not been followed. My experience is that the Federal courts are quite attentive to failures by regulatory agencies to follow the rules that are set out for them.

Mr. GREEN. And in that process would a Prudential or any entity have an opportunity to have some degree of discovery?

Mr. BARR. I haven't looked carefully at what materials were already provided and what would be protected material and not protected material in that context. They would certainly be able to gather and present information about whether the procedures were followed and whether the standards set forth in the statute were met in their case.

Mr. GREEN. Let me just close with this comment. Assuming that Prudential disagreed, and a lot has been said about Prudential, there was the ability and the right to appeal. A $1 trillion corpora-

tion which had the ability to hire good lawyers, could have appealed, and did not do so.

Mr. BARR. Correct.

Mr. GREEN. I trust the judicial system in this country. I don't always agree with it. And I think that in and of itself gives FSOC some credibility, as well as OFR, because the appeal process is readily available to any company that believes it has a grievance as a result of a decision made by FSOC.

Thank you, Mr. Chairman.

Mr. LUETKEMEYER. With that, we will turn next to the gentleman from New Mexico, Mr. Pearce.

Mr. PEARCE. Thank you, Mr. Chairman.

And I thank each one of you for your presentations here today.

Mr. Barr, Mr. Scalia was very precise in his descriptions of the Prudential decision. He says it presupposes severe financial distress with no consideration at all to whether there is any indication that such distress is likely to occur, then relies on a broad unsubstantiated assertion to conclude that material financial distress could pose a threat. Do you have an opinion about that same case that would differ from the observations by Mr. Scalia? Because to me, sitting up here, I find those accusations to be intensely interesting in the process. And so, do you find that not so concerning as he does?

Mr. BARR. I have not reviewed in detail the Prudential case to judge item by item what my views of the substantive merits are.

Mr. PEARCE. Okay, that is fair.

Mr. BARR. I would say that the process that the FSOC followed with respect to that decision was an engaging and searching process, at least as it appeared from the outside. I am just judging based on the extensive review process that they engage in, the provisional determination, and then final determination.

Mr. PEARCE. In your testimony, you indicate that Dodd-Frank was created to create a system of supervision which ensured that if an institution poses risk to the financial system, it would be regulated, supervised, blah, blah, blah. So you lay out the requirements. Are Fannie and Freddie supervised under Dodd-Frank?

Mr. BARR. Fannie and Freddie are currently supervised by the FHFA under the authority granted through HERA.

Mr. PEARCE. Do they come under FSOC?

Mr. BARR. I think that one could make a case that they are subject to the same rules as anyone else and that the FSOC should review them.

Mr. PEARCE. I am taking from your answer that, no, they don't, they are not currently included in the scope of work of the FSOC.

Mr. BARR. No, I wasn't saying that, sir. I was saying that I think that under the provisions of the Dodd-Frank Act, the Dodd-Frank Act could provide authorization for FSOC review of those entities. I have no idea whether or not they are separately under FSOC review. Obviously, the FHFA is their current regulator and sits on the FSOC.

Mr. PEARCE. If I could take the time back, there are many people who think they don't come under the, that they are limited from discussion of those two entities, and definitely they do have the po-

tential, they are big enough size to where they might ought to be considered.

Mr. Scalia, you had mentioned in one of your comments that the access to FSOC data is closely guarded. And so my question is, what are the risks if—is that data fairly important in a competitive sense, fairly important to other firms, the data that is being collected?

Mr. SCALIA. I'm sorry, the question is whether designation is important?

Mr. PEARCE. No, no, no, whether the access to the data, that data that is collected, is that fairly important data in a competitive sense?

Mr. SCALIA. Some of the data can be competitive. However, much of the data that FSOC compiles and presumably relies upon in its designation decisions is about markets generally. And there has been discussion about the appeal process, for example. Ordinarily in, say, an appeal process where a record is created before the agency, the parties who are going to be affected get the chance to see that and to provide their views so that they are heard by the decision-maker. But that kind of opportunities is not being provided.

Mr. PEARCE. But there is not any data that would be critical if it is released? That is my question then.

Mr. SCALIA. There can be some sensitive data about the individual companies being considered. Of course, there is no reason those companies themselves can't see the data about themselves. But if there were public disclosure of FSOC proceedings, you would want care about that, but there is market economic data that is not sensitive and should be available.

Mr. PEARCE. Okay. I just wondered if you had a Snowden-type release, somebody goes in and takes everything and releases everything, that is fairly more plausible today than we might have thought it was a couple of years ago. So, it is just this accumulation of financial data I always worry about.

Mr. Barr, should the FSOC consider the pension funds? The estimates are that they are trillions overdrawn. They pull money in, distribute money out, so they are kind of a bank in the system. Should the FSOC be looking at pensions?

Mr. BARR. I think the FSOC should look at risks throughout the financial system. Whether or not that is in furtherance of some regulatory goal or just to understand risks in the system I think is not the issue, but having the ability of the FSOC to look broadly across the financial sector and to see where risks are arising, I think is important.

Mr. PEARCE. Thank you. I yield back, Mr. Chairman.

Mr. ROSS [presiding]. Thank you. The gentleman's time has expired.

The gentleman from Delaware, Mr. Carney, is recognized for 5 minutes.

Mr. CARNEY. Thank you, Mr. Chairman.

And thank you to all the panelists today. It has been a very interesting discussion. I would like to return to the discussion we had led by the gentleman from Alabama, Mr. Bachus, around whether mutual funds present a systemic risk. During that conversation,

Mr. McNabb described the way mutual funds were structured, at least Vanguard was structured and kind of walled off, if you will. And it seemed like there was considerable disagreement among the panelists about whether mutual funds do pose those kinds of systemic risks.

And, Mr. Barr, I was wondering what your reaction was to Mr. McNabb's description? I got the impression that you believe that mutual funds oppose those systemic risks. Could you explain to us why you think that is the case?

Mr. BARR. I think that asset managers and banks have fundamentally different business models and fundamentally different balance sheets and fundamentally different risks that they face.

Mr. CARNEY. So you agree with me?

Mr. BARR. The particular issue that I was addressing was risk to the system from a particular form of mutual fund, money market mutual funds that are able to maintain and promise, in essence, a stable net asset value. And that could—

Mr. CARNEY. If I may interrupt, because we only have a limited amount of time, so the SEC is dealing with that issue in terms of the floating NAV and they have a whole series of regulations. And I don't know, there has been some discussion and some disagreement on the committee and in the industry about that, but that is moving in a separate way. So do you believe, then, that because those money market funds pose systemic risk that the other mutual funds should be swept in as SIFIs as well or the larger entities that have those mutual funds?

Mr. BARR. I think that the presence of risks in the system may or may not be appropriately dealt with by designation. There are lots of other regulatory tools. In the case of money market mutual funds, I think having the ability to either impose capital requirements on stable funds or to float the NAV is an appropriate response that is aside from designation. And similarly, in the asset management field as a whole, there are operational risks that if they are of sufficient concern can be addressed in existing frameworks with or without designation. So I don't think that everything, the risks in the systems hinge on designation or not designation. They are about appropriately tailoring a regulatory response to the risk that you see.

Mr. CARNEY. Fair enough.

I would like to move on to the bank designations of SIFI. There are Members on both sides of the aisle here who have been looking at how to differentiate those designations beyond the $50 billion threshold, if you will. In fact, Governor Tarullo, I think last week at a speech at the Chicago Fed, said that he believed that we should take another look at that and maybe firms under $100 billion shouldn't be subject to designation as an SIFI.

Mr. Smithy, I assume you would agree with that? There is legislation here many of my colleagues have put forward to differentiate among banks differently than just a $50 billion or a $100 billion threshold. Do you have any thoughts on that?

Mr. SMITHY. So, again, we would agree that an arbitrary asset-only threshold would not be appropriate. Simply raising it to $100 billion, though, I don't think solves the issue. We would favor a multifaceted approach, which is activity-based, to determine who is

indeed an SIFI based on the range of practices within the organization and the risks they pose.

Mr. CARNEY. So the kinds of activities like, for instance, what would it be? There is a bill I think Mr. Luetkemeyer is the lead sponsor on, I am looking at my colleague Ms. Sewell, I believe she is a cosponsor of that bill, that would differentiate based on activities, how risky they might be. Is that what you are talking about?

Mr. SMITHY. Absolutely. We would expect they would review whether or not you are engaged in significant international activities, trading activities, whether or not your institution is substitutable, and the complexity of your overall organizational structure.

Mr. CARNEY. I have 29 seconds left. Does anybody else have any thoughts on Mr. Tarullo's comment about the $100 billion threshold? Mr. Atkins?

Mr. ATKINS. Yes, I think that I agree with the panelists here that all of these thresholds are very arbitrary. And so, I think they are actually counterproductive.

Mr. CARNEY. So it is not really the thresholds, it is the activity, in your view?

Mr. ATKINS. Right.

Mr. CARNEY. Everybody seems to be shaking their head.

Mr. Barr, would you agree with that? I think you did.

Mr. BARR. I think that within the existing framework you can tailor and graduate the extent of regulatory compliance. I don't think it needs a legislative fix, but I agree that much more nuance could be in the system than is there now.

Mr. CARNEY. Thank you very much, each and every one of you.

Mr. ROSS. Thank you.

The Chair now recognizes himself for 5 minutes.

Mr. Wallison, it was interesting to read your opening testimony, and in it you state that FSOC uses the word "significant" 47 times in their 12-page statement designating Prudential as an SIFI. And being a litigator for 25 years, I know that when we have ambiguities we try to look at the plain meaning of either the statute or the word to determine what was intended. Based on your extensive legal background, do you have any definition for the word "significant" that is being used?

Mr. WALLISON. No, sir, I have no definition for that.

Mr. ROSS. I guess my question is, how can these organizations that are under review for SIFIs anticipate whether they are going to be designated as such when we really can't get our hands around what "significant" means? As you point out, it is very arbitrary.

Mr. WALLISON. It is arbitrary, it is not a standard, it is not something that anyone can use to adjust, no firm can use to adjust its activities. There is really no information that is conveyed by that term.

Mr. ROSS. So not only in the assessment of the organization, but then after the assessment or designation, if you will, other organizations—once Prudential is designated, then how can another insurance company, if you will, act accordingly to make sure that they are not so designated? There is no road map, in other words?

Mr. WALLISON. There is no road map. I mentioned before that the IAIS, which is an international insurance group, had set up a

methodology for making this kind of determination, and they actually put percentage weights on things. That was a very valid way to proceed. That doesn't necessarily mean I agree with it, but it is a valid way to proceed. That was ignored by the FSB.

Mr. ROSS. So organizations, a company today has no real road map to avoid being designated as an SIFI until it is too late?

Mr. WALLISON. That is right.

Mr. ROSS. When we look at the McCarran-Ferguson Act, which I think has been very good for this country for consumers' purposes and regulating insurance based on a State-by-State assessment, don't you foresee that there is going to be some serious conflicts there once an insurance company may be designated as an SIFI in trying to maintain certain capital requirements, either as risk-based capital versus GAAP accounting? How does that help the consumer?

Mr. WALLISON. This is pretty radical, what we are talking about here, and this is something that has never happened before, and that is that an entire industry will be bifurcated between those that are regulated at the Federal level by the Fed differently.

Mr. ROSS. Do they keep a separate set of books?

Mr. WALLISON. In many ways, of course. But differently by the Fed, with different capital requirements from the other similar although smaller institutions that are regulated at the State level. This will be a very difficult thing for—

Mr. ROSS. And a very expensive thing.

Mr. WALLISON. And very expensive.

Mr. ROSS. Mr. McNabb, just briefly, with regard to the Basel-type approach of capital requirements and applying it to asset managers, aren't we really just not only saying to asset managers what capital they can or cannot reserve, most likely they must reserve, but aren't we also just basically telling them what they can and cannot invest in?

Mr. MCNABB. I think that is one of the potential consequences of prudential regulation of asset managers, is that we as asset managers could be put in a position of conflict where we are told for "safety and soundness reasons" to either invest in something or not invest in something when it is not in the best interests of the shareholders or in the prospectus that we have delivered to the shareholders.

Mr. ROSS. And don't you foresee that leading to a new cause of action? If your fiduciary responsibility is to your clients, and now we have this regulatory arm telling you what you can and cannot do, and basically who is your obligation to? I guess what I foresee here is, is that once asset managers are brought under this tent, I foresee in some of the creative ways a new cause of action being created that would lead to litigation, and then greatly increase that $108,000 assessment that now is going to be placed over the life of the investment, according to Mr. Eakin.

Mr. MCNABB. It is a very large concern.

Mr. ROSS. One last thing, I understand that there is a genuine relationship between risk and return, and they are directly related. The higher the risk, the greater the return. But aren't we, what we are trying to do now is to eliminate any and all risk and as a result lower the return? If we are going to lower the return, how do we

anticipate for retirement purposes and, more importantly, addressed for student loans, which is right now the largest liability that this country has?

Mr. MCNABB. Mr. Chairman, I think you make a good point in that there is a lot of confusion between what I would call idiosyncratic risk, which is the individual risk of a single fund or a single entity, versus systemic risk, and I think to other panelists' points earlier, there has not been a clear definition of what systemic really means versus what we all know is idiosyncratic today.

Mr. ROSS. Thank you. I see my time has expired.

I now recognize the young lady from Alabama, Ms. Sewell, for 5 minutes.

Ms. SEWELL. Thank you, Mr. Chairman.

I want to thank all of our panelists for a very interesting discussion today.

I wanted to address my questions to Mr. Smithy. Can you talk to me a little bit about the difference between—in your testimony you talked about a business model of regional banks versus your larger peers, and really making the case that regional banks should be treated differently. Could you elaborate a little bit on that model?

Mr. SMITHY. Absolutely. So as I stated, we are traditional lenders. We focus primarily on smaller to medium-sized markets, whereas some of our larger bank competitors are in the larger metro markets, would focus on larger companies. We are focusing on small businesses and medium-sized businesses, traditional lending products, and traditional deposit products as well. We are not engaged in complex trading activities, we don't make markets and securities, and we don't have meaningful interconnections with other financial firms, which I think is a key differentiator between us and the larger banks.

Ms. SEWELL. What about the supervision that you currently have? If you are not designated as systemic, don't you feel that the current supervision model that you are operating under would prevent regional banks from being sort of swept into the same systemic risks?

Mr. SMITHY. Assuming we would go through an evaluative process such as what is presented in the Luetkemeyer bill, even if we were deemed not systemic, the regulators still have a suite of processes that they put us through, annual stress test, required capital plans, as well as on-site reviews, along with the Basel 3 capital and liquidity rules, that we think would be sufficient for regulation of regional banks in the range of practices in which we are engaged.

Ms. SEWELL. How do you think the regulators would deal with a regional bank failure in such that compared to sort of what Dodd-Frank would make you do if you were a systemic institution?

Mr. SMITHY. As you know, the regional banks have recently submitted, at the end of last year, a resolution plan which we think will lay out or will suggest that regional banks are resolvable under the traditional bankruptcy framework, either in whole or in part. I think clearly there is a range of sizes we are talking about here within the coalition. We think that all of the banks' business models within the coalition are fairly homogenous, and so therefore again can be either resolvable in whole in a normal purchase situa-

tion or in part and absorbed into competitors across their footprints.

Ms. SEWELL. Great.

Mr. McNabb, I wanted to ask you how you thought the asset managers being designated as SIFIs would affect investors? We have talked a lot about your business model and how it affects asset managers, but what about investors?

Mr. MCNABB. I think, again, we don't know the exact remedies being designated, but if you look at what has been suggested, costs for investors for those in designated firms or designated funds would go up. And so, again, our estimate was a quadrupling of fees in a couple of our most basic funds. That is going to vary, obviously, firm to firm.

I think you are also going to see a situation, though, where the competitive landscape is altered. So if you were to look at the FSB's designation process or at least what they suggested, they named 14 U.S. funds, which comprise roughly 1 percent of the world's market, as being systemically important. And if you are an investor you might ask yourselves, why would I invest in one of those funds when there is a like product where I am not going to be designated and I am not going to have to pay these additional fees and possible resolution costs and so forth?

Ms. SEWELL. I know that mutual funds are currently subject to comprehensive regulations that serve both to protect the shareholders as well as to reduce the potential for systemic risks. For example, funds have strict limits on your leverage and diversification requirements. Can you discuss how these regulations distinguish mutual funds from other financial institutions and the impact their potential would have on posed systemic risks.

Mr. MCNABB. Yes. So I think you hit on actually some of the most important points. Transparency is very important and funds are valued every day, so an investor knows what his or her value of the portfolio is. There is little to no leverage in all funds. There are extremely clear reporting requirements and transparency to the end investor. So when you add that up, you have a very heavily regulated product that is really very low risk from a systemic standpoint, not to say that there aren't idiosyncratic risks within each individual fund.

Chairman HENSARLING. The time of the gentlelady has expired.

The Chair now recognizes the gentleman from Kentucky, Mr. Barr, for 5 minutes.

Mr. BARR OF KENTUCKY. Thank you, Mr. Chairman.

Mr. Scalia, in your written testimony, and in your verbal testimony, you made the point that FSOC's regulations and interpretive guidance have done little to give potentially regulated parties adequate notice of the legal standards that will be applied to them and whether, in view of those standards, they are likely to be designated systemically important, and what changes that they could make in their structure operations so that they are not so designated. Short of abolishing FSOC, what policy recommendations would you offer to Congress to either more clearly define FSOC's standards that they use or what changes could we make to FSOC to provide regulated parties more notice, more concrete notice?

Mr. SCALIA. I think that deliberations such as this are a valuable step forward. One hopes that FSOC's members are paying attention to the discussion today and will take account of those things.

The Dodd-Frank Act itself requires FSOC to consider other risk-related factors beyond those that are enumerated in the statute, and one of those factors plainly is the risk to the company and its customers and shareholders of designation. FSOC hasn't thought about that yet. So I think that much of what would be helpful is in the statute.

I did want to briefly talk about the Prudential decision, and there were questions asked earlier of Mr. Barr regarding Prudential's decision not to appeal. There are, as actually Professor Barr I think quite fairly said, a number of different reasons that a company would decide not to take the government to court. That is a big step. But the question shouldn't merely be, well, what opportunity do you have to go to court when the government has made a serious mistake and violated your rights? The mere fact that the government has made a serious mistake and violated your rights is troubling enough. Even when you decide not to seek government recourse, we have this body, as well as the courts, to oversee what agencies are doing, and I think that is an important dynamic regardless of the decision of an individual company not to take the government to court.

Mr. BARR OF KENTUCKY. As an administrative law practitioner, what would be helpful in terms of additional direction from Congress in terms of how FSOC operates?

Mr. SCALIA. I think that the statute as written should be one that FSOC could administer to give much greater respect to participating companies' rights than it gives currently. But that said, I think a significant improvement would be if FSOC considered companies on a broader sort of industry-wide type basis rather than singling them out one by one. Now, I don't think that the statute has to be read to require singling them out one by one, but that is what it is doing, and I think one change to be considered is that.

There is proposed legislation to increase transparency. That could be valuable. Perhaps most important, when you look, for example, at both insurance companies and mutual funds, is the problem of FSOC designation resulting in the imposition of bank-based capital standards, which is what Fed Members have indicated necessarily follows. There is legislation pending that would make it clear that is not required, and I think that would be an important change, too.

Mr. BARR OF KENTUCKY. I think the fact that former Congressman Frank, for whom the Act was named, said that it was not his intent that asset managers be designated as SIFIs says a lot about the designation process.

And as a segue, just a final question to Mr. McNabb. Obviously it is your position that the application of bank-like regulation of mutual funds would not limit systemic risk, but would obviously disrupt capital markets and increase costs for your investors. What is your amplified opinion about what this would do not only to your investors, but to the capital markets and capital formation and the ability of retail investors to provide liquidity to our commercial system?

Mr. McNABB. That is a very hard question to completely speculate on, but higher costs, if the cost of capital goes up dramatically—and the mutual funds are roughly 25 percent of the U.S. equity market, so it is a very important source of funding—if that cost of capital goes up dramatically, then by definition, you are going to have slower growth. And if we have slower growth, it is going to create less jobs and so forth.

Mr. BARR OF KENTUCKY. Thank you. I yield back.

Chairman HENSARLING. The time of the gentleman has expired.

The Chair now recognizes the gentleman from Illinois, Mr. Foster, for 5 minutes.

Mr. FOSTER. Thank you, Mr. Chairman.

And thank you to all the witnesses.

It seems to me that the SIFI designation process in principle has the opportunity to take risk out of our system by negotiating the business model for a firm that is under consideration for SIFI designation. So my question, I guess to Mr. Scalia, if you could discuss the actual process that the analytical staff at the FSOC play in the review and designation process, and specifically with respect to the reports that the staff at each agency produces for the voting member and how important the meetings are, and is there a to and fro between the analytical staff from each Council member and the companies under review?

Mr. SCALIA. I will do my best to describe that process, although part of the challenge is that it is opaque. But the essential process is that a company is told that it is under consideration after a point, is required to submit information, and may submit additional information, and then has opportunities to meet with the staff to make presentations and answer their questions. However, what is not known is what additional information and reports the staff and the members may have access to. Those aren't shared with the company that is under consideration until at earliest when there is what is called a proposed designation decision.

Now, once there is a proposed designation decision, a written explanation of some sort is provided to the company which can take an appeal which has been described. But here is what is really unusual. The FSOC members make the proposed designation, and then internally at FSOC, who do you appeal to? The same people. I am not familiar with another legal process like that where a group of people makes a decision against you, and you get to appeal to them to try to persuade them to change their minds. That is not really an appeal. I think at that stage, too, there is a real question of the extent to which the company has access to the data in the reports that FSOC is relying upon. Ordinarily, that would be provided.

Mr. FOSTER. So you wouldn't really characterize it as being a negotiation where the business model could be adjusted. And what I am fishing for is whether potentially some future AIG, they could have said, look, if you stay away from securities lending, stay away from credit default swaps, you are going to maintain a lower level of SIFI designation. But that sort of negotiation, to your knowledge, doesn't really happen here?

Mr. SCALIA. I am not aware that it has occurred. And this relates in part to the question about clear standards that has been dis-

cussed earlier. If there were clear standards, then companies would be able to look at how they are currently doing business and saying, oh, if I change these couple of things, then I wouldn't be supervised by the Fed and have all the added costs for my customers and shareholders. But that opportunity is not present now.

Mr. FOSTER. Now, I sense a lot of enthusiasm from the panel for gradations in oversight and SIFI designation, that having it be an approximately binary thing makes it uncomfortable in a number of ways. And I accept Professor Barr's point that there, in fact, are different levels of oversight depending on the exact nature of the company.

But my question is, is there a problem with—there is a bailout mechanism for assessing industry fees to other SIFIs if one of them has to be bailed out, and so is this adequately transparent? I think, when was it, Long-Term Capital had to be bailed out, there was an assessment after the fact of I think 14 different financial services companies chosen somehow, which I think was probably not a very transparent operation, but I was wondering is there a view that there is a lack of transparency for a future assessment when that mechanism is called into play? Anyone?

Mr. BARR. Let me just take a first stab. The FDIC is authorized under the statute, required under the statute to provide for the assessment schedule, and so there is a process under which people can comment, provide notice and comment, provide input into that. And so the basic rules of the game I think are able to be reasonably established in advance. The caveat to that is, of course, you don't know in advance whether a particular firm will be subject to resolution, whether that firm will be resolved with the assets that are available to the firm or the FDIC would be required to borrow, and if it borrowed, what that amount would be.

Mr. ATKINS. I think that is the problem of Section 210(o) of Dodd-Frank where it gives the FDIC huge discretion in this, in the future. And so folks, if they go down the line to designate asset managers, you will have real investors, if they have to pony up capital, then subsidizing the too-big-to-fail banks or whichever institutions fail.

Mr. FOSTER. Which is one of the reasons that companies are kicking and screaming to not be designated because it makes an unknown potential burden on them.

Mr. ATKINS. And investors are kicking and screaming.

Mr. FOSTER. Right, right. Whereas, a multitiered designation might avoid some of that.

Mr. ATKINS. And, in fact, one of the problems is, I think, the FSOC has flouted Congress, because Congress in Title I of Dodd-Frank told the FSOC to come up with parameters for this designation process. FSOC basically regurgitated the statute in its rule.

Chairman HENSARLING. The time of the gentleman has expired.

The Chair now recognizes the gentleman from North Carolina, Mr. Pittenger, for 5 minutes.

Mr. PITTENGER. Thank you, Mr. Chairman.

And I thank you gentlemen for being here today. You have discussed, I know, the heightened prudential standards that we have on insurance companies, but what do you think will happen 5 or 10 years down the road? Give me your perspective of applying

these bank-like risk capital requirements to insurance companies. Could we start with Mr. Wallison?

Mr. WALLISON. One of the problems here, of course, is that we don't have any idea what kinds of standards are going to be imposed eventually by the Fed. The Fed will do the imposing and they have not indicated yet, first of all, whether they are actually bound to do that. They say they are, but we don't know what they mean by that. And then, secondly, after a period of 5 or 10 years, what we might find, and this would be the most troubling thing, is that the ones that are subject to these bank-like capital standards are failing as a result of the fact that they are subject to standards that don't fit with the way an insurance company works.

And so, we then have these very large financial institutions that are being driven out of business by their regulatory process. That should be unacceptable. And one of the reasons we should stop this SIFI process is to make sure that the FSOC itself knows what the Fed is going to do when it gets hold of an insurance company or an asset manager, for example.

Mr. PITTENGER. Mr. Scalia, would you like to comment on that?

Mr. SCALIA. Just to add to that, that is a central question, and it is one FSOC itself has never asked, much less answered during the designation process, what will result once we designate this company as a consequence of the new regulatory requirements. They haven't been determined, but the Fed has indicated they will be bank standards.

The concerns I think are a couplefold. One is the competitive burden, which Mr. Wallison has talked about. It is so extraordinary to take as broad an industry as, say, insurance or mutual funds and pick three or four or five companies in this enormous industry and only treat them to a different regulatory set of requirements. I have not seen that done elsewhere. I believe there is also risk that bank-based standards will just inaccurately reflect the real risk on the books of an insurance company or mutual fund, overstating that risk sometimes, potentially understating sometimes, not providing accurate read back to investors and regulators the way that standards designed for insurance companies already do.

Mr. PITTENGER. Thank you.

We have a diverse economy that I think we all agree is better served by a very diverse financial set of institutions. Are you concerned with the shrinking number of financial institutions? I know we have lost, I think, 1,700 banks in the last couple of years. Do you think that our policies are driving this trend? What would you do to mitigate that? Do you think it makes sense to regulate large internationally active money centers the same way that you are going to regulate smaller banks?

Mr. Smithy from Regions?

Mr. SMITHY. Thank you. So, no, as we have stated, we think it is inappropriate to have the same regulatory framework and the same standards for banks of all sizes, and in fact just establishing an asset-only threshold does not get at the heart of the inherent risk of the banks. We are more in favor of having regulation that is tailored to the specific risks of the banks. So we would not think that is appropriate.

Mr. PITTENGER. Mr. Atkins?

Mr. ATKINS. Yes. I think part of the problem that we have with respect to the banks in particular is the huge power of bank examiners and the bank regulators in a very arbitrary and capricious way to deal with banks in their regulatory realm. So I think that is what a lot of us—I was a Commissioner at the Securities and Exchange Commission where things tend to be more transparent, or hopefully so, than as compared to the banking side—I think that is what we are concerned about with respect to this potential designation process.

Mr. PITTENGER. Mr. Wallison?

Mr. WALLISON. In my prepared testimony, Congressman, I have a chart which shows that the capital markets and securities business has far outcompeted the banks in financing business. And one of the reasons they are doing that is that the banks are heavily regulated and very expensively regulated so that, as we just heard, more people are involved in the business of compliance than are actually making loans. That is a very troublesome thing and one of the reasons why the banks cannot provide the kind of financing that is much more efficiently provided by the capital markets.

Mr. PITTENGER. It is troubling when the only jobs you create are compliance officers.

Thank you. I yield back my time.

Chairman HENSARLING. The Chair now recognizes the gentleman from Illinois, Mr. Hultgren, for 5 minutes.

Mr. HULTGREN. Thank you, Mr. Chairman, and I am banking on the concept that the last shall be first one day.

First, I want to address this to Professor Barr. Earlier, I know you said to Mr. Bachus that you think congressional oversight of FSOC would jeopardize its "independence" and therefore—

Mr. BARR. Could I just correct that?

Mr. HULTGREN. First of all, I disagree with that concept. I wondered if you would extend that rationale to other financial regulators. Should we stop all oversight of the Fed, the SEC, the OCC? Why should FSOC be beyond accountability to my constituents?

Mr. BARR. Oh, I completely agree that it should be subject to full and complete congressional oversight. My response to Mr. Bachus was to his suggestion about whether a Member of Congress should participate in FSOC meetings. And my comment was that participation by Members of Congress in FSOC meetings would undermine Congress' independence in exercising exactly the kind of oversight that you are doing today and that I think is absolutely critical to a functioning democracy. So I am 100 percent in favor of the oversight you are exercising on the FSOC and on the other financial regulatory agencies.

Mr. HULTGREN. I appreciate you clearing that up. So you do support accountability and transparency and oversight there.

Let me get on to some other things because I have some other questions I want to ask here quickly. I know throughout the hearing today we have discussed FSOC's SIFI designation authority, which lets the FSOC impose a costly regulatory regime upon certain financial institutions. Unfortunately, I see that this largely unchecked authority will end up hurting Main Street instead of protecting it because it imposes unnecessary regulatory costs upon institutions that really pose no systemic risk to our financial system.

I want to ask about the structure of the FSOC itself and if it requires regulators to rule on topics in which they really have no expertise. One of the reasons that Congress delegates the task of regulation to independent regulatory agencies is that we expect the agencies to use their expertise and experience to tailor regulations that are effective and appropriate to meet specific needs without being unduly burdensome. I wonder, is the FSOC structure consistent with this expectation and does the FSOC structure give appropriate deference to experience and expertise?

Maybe I will just start with Mr. Wallison, if you have a thought on that?

Mr. WALLISON. I think that the Prudential case shows precisely the question you are asking is a problem. The two members of the FSOC who were insurance specialists and experts and are not employees of the Treasury Department dissented from the decision in the Prudential case, but it was voted overwhelmingly to designate Prudential. And who voted for that? It was bank regulators and it was regulators of other kinds of financial institutions, none of whom knew anything about what regulation of an insurance company would entail. In addition, they dissented because they thought that the standards that were imposed for the designation were also wrong. And, again, nobody paid any attention to them.

So if we are going to have regulators, we want them to be specialists, we want them to understand the industries they are regulating fully, and here we have a set of regulators who can't possibly understand all of the nuances of the individual industries that come before them.

Mr. HULTGREN. I want to try and ask one last question in my minute left. As everyone knows, last September the Office of Financial Research released a study on the risks associated with the asset management industry. This study achieved instant notoriety here in Washington as it was criticized by almost everyone. Better Markets, which is not normally thought of as a bastion of deregulatory zeal, pointed out the inexplicably and indefensibly poor quality of the work presented in the report. In particular, most observers believed it largely ignored the extensive regulation of mutual funds that exist already and focused on dozens of hypotheticals about remote risks that are extremely unlikely ever to happen.

My question is, what happens if the FSOC implements the logic of this flawed study and designates certain asset managers as SIFIs? Mr. McNabb, I know that this hearing has focused on how asset managers help everyday Americans. The problem is that people look at a company like BlackRock, which has around $4 trillion assets under management, and don't think that it provides a Main Street service. I wonder if you could explain why it does?

Mr. MCNABB. Far be it from me to talk about one of our largest competitors, but I will attempt to do the best I can.

Mr. HULTGREN. Sorry about that.

Mr. MCNABB. BlackRock manages nearly $2 trillion in mutual funds of that $4 trillion, and those mutual funds, much like ours or Fidelity's or T. Rowe Price's or any of the other big firms that you are familiar with, serve Main Street. Collectively, the mutual fund industry serves 95 million investors, roughly one out of every

two households. BlackRock also manages very large amounts of pension funds, which benefit everyday workers.

Mr. HULTGREN. My time is pretty much up. And you would say other companies are in that similar situation of providing that service to Main Street?

Mr. MCNABB. Totally.

Mr. HULTGREN. With that, I yield back, Mr. Chairman. Thank you.

Chairman HENSARLING. The time of the gentleman has expired. There are no other Members present in the queue, so I would like to thank our witnesses for their testimony today.

The Chair notes that some Members may have additional questions for this panel, which they may wish to submit in writing. Without objection, the hearing record will remain open for 5 legislative days for Members to submit written questions to these witnesses and to place their responses in the record. Also, without objection, Members will have 5 legislative days to submit extraneous materials to the Chair for inclusion in the record.

This hearing stands adjourned.

[Whereupon, at 1:08 p.m., the hearing was adjourned.]

A P P E N D I X

May 20, 2014

<u>"Why FSOC Should Not Designate Mutual Funds as SIFIs"</u>
Paul S. Atkins
Hearing – Financial Services Committee, U.S. House of Representatives,
May 20, 2014

Good morning. I am Paul Atkins, CEO of Patomak Global Partners. For six years ending in 2008, I served as a Commissioner of the Securities and Exchange Commission and was a member of the Congressional Oversight Panel for TARP. I am testifying this morning on my own behalf.

* * *

As I am sure you know, under Dodd-Frank, the FSOC has statutory authority to label entities within the financial services industry "Systemically Important Financial Institutions," abbreviated as S-I-F-I.[1] The other day, a former Chairman of this committee, Barney Frank, quipped that "SIFFY," as some pronounce it, sounds like a disease. He's right – but there's more. SIFI designation is the statutory gateway to a new level – and for some entities, a whole new *world* – of regulation by the Federal Reserve. Those are the reasons why I insist that my pronunciation – Sci-Fi's – is necessary and correct. FSOC's *"Sci-Fi's"* take us way out there to a world of unreality that exists only in the fertile imaginations of an unaccountable few.

This morning, I would like to focus on the problems inherent in using the FSOC's authority under section 113 of Dodd-Frank to designate regulated investment funds – specifically, mutual funds – as SIFIs. Section 113 makes clear that the purpose of SIFI designation is to subject designated non-bank entities to prudential supervision by the Federal Reserve in the interest of promoting the safety and soundness of the U.S. financial system. Once under the Fed's supervisory umbrella, the non-bank financial company will be subject to any "enhanced supervision and prudential standards" that the Federal Reserve may adopt at the FSOC's recommendation.[2] Once under the Fed's regulatory umbrella, SIFI-designated funds can expect to be subjected to bank-like capital requirements. [3]

Therein lies the problem: One simply cannot assume that an enhanced supervisory structure designed to stabilize very large banks is equally well suited to other financial entities with radically different structures and risk profiles. Indeed, given the considerable differences in how such institutions and funds are structured and operate, one should expect that applying the same regulatory standards would yield at least some unexpected and perhaps quite undesirable outcomes. I want to

[1] Dodd-Frank Act, sec. 113.
[2] Dodd-Frank Act, sec. 115.
[3] Dodd-Frank Act, sec. 171(b)(7).

stress that that's just as true if you are a proponent of the various initiatives taken in the Dodd-Frank Act as if – like me – you are not. Let me explain.

To date, FSOC has designated three non-bank financial companies and eight financial market utilities as SIFIs, subjecting them to the Fed's prudential supervision.[4] Implicit in these designations, as well as in the statutory authority from which they stem, is the belief that the largest banks and non-bank financial companies share characteristics that would make the Fed's prudential supervision and capital adequacy requirements an appropriate – that is, helpful and effective – regulatory approach. The trouble with that theory is that banks and managed investment funds like mutual funds are, in *fact*, fundamentally different. To regulate them as though they were the same would be a mistake with enormous implications. Moreover, the effect of a large bank's failure on the financial system would be massively and materially different from any risks that could be created by even the largest investment fund.

Start with this: Banks take deposits; the resulting obligations are bank indebtedness. Mutual funds take investments; the investor's equity in the fund is a contractual right to a pro rata participation in the investment fund's gains and losses. Investment fund managers are in an agency relationship to their investors. They have a fiduciary obligation to their funds – with the corollary that their judgment as fiduciaries could be at odds with what an outside prudential regulator might require. Banks, unburdened by fiduciary obligations to their depositors (they act as principals) face no such potential conflict of interest.

The differences do not end there. The largest – SIFI-designated – banks, are huge; the largest U.S. "systemically important bank" has assets of $2.4 *trillion*, and the *average* "systemically important" U.S. bank has $1.28 *trillion* in assets. The largest regulated investment funds – all of them in the United States – are orders of magnitude smaller, averaging a relatively modest $159 *billion*.[5] Moreover, while banks are deeply intertwined with other key participants in the financial system, investment funds are essentially freestanding. Whatever dangers the current batch of regulators see lurking in banks' "interconnectedness" – fears which I think are overblown – certainly do *not* exist with respect to mutual funds. The point, then, is that regardless of what measure we use, putting banks and mutual funds into the same regulatory basket is to embark on a fool's errand with half a map.

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Now, I would be the first to acknowledge from long and sometimes painful experience that not everything the SEC does is wise. Nor am I here to defend the

[4] *See* http://www.treasury.gov/initiatives/fsoc/designations/Pages/default.aspx.
[5] *See* figures in App. B to ICI's April 7, 2014 letter to the Secretariat of the Financial Stability Board, at pp. B-3 - B-4 (based on 2013 data from the FDIC and Lipper), reprinted at: http://www.ici.org/pdf/14_ici_fsb_gsifi_ltr.pdf.

SEC's jurisdiction. If this were some sort of "turf war," you wouldn't be hearing from me about it. Even so, there can be no question about whether the SEC is expert at regulating capital markets – *risk* markets. It *is* expert, and it has no close competition – certainly not the Fed. That's simply *not* what the Fed does – much less the FSOC. Let me take a minute to explore that with you.

The Fed, as our central bank and the nation's lender of last resort, is concerned with overall maintenance of a stable banking system. It is a *prudential* regulator concerned with the safety and soundness of the banking system and, by extension, our larger financial system. Accordingly, the Fed's core concern is with capital adequacy – whether the banking system, in which leverage is inherent, is adequately capitalized and sufficiently liquid to meet its obligations as they come due.

The SEC, by contrast, functions more like an umpire of the U.S. capital markets, with a professed goal of using both its rulemaking and enforcement authority to keep those markets free and fair. The Fed, then, is in the capital assurance business, while the SEC is overwhelmingly focused on the actions and activities of participants in U.S. capital markets. For the SEC, the liquidity of risk-taking entities is generally the issue, rather than their capitalization.

Contrast the Fed, which regulates to preferred outcomes – after all, central bankers are central *planners.* The SEC tends to train its regulatory focus on activities, setting outer limits on what capital markets participants may do and enforcing those limits as necessary – again, the capital markets' umpire at work. The point is simple: Not only is there a big difference between the Fed's objectives and expertise and that of the SEC, but the implications stemming from that difference are enormous when it comes to regulating non-bank financial entities, particularly investment funds.

* * *

When you or I invest in a mutual fund, we buy shares in that fund; as a result, we participate in the fund's gains and losses. We can redeem our shares for whatever they happen to be worth when we elect to redeem them. But we are not assured of making a profit – or even of getting our money back. We made an investment and to that extent have put our invested funds at risk. We may – and certainly hope to – do far better than we would by putting that money into, say, a savings account. Our investment risk, in other words, correlates to our desired returns.

That's a classic, if simple, description of what happens in capital markets – investment risk correlated to potential reward. It stands in contrast to the deposit and lending model banks employ. The SEC's entire experience and focus is on maintaining free and fair capital markets, while the Fed exists to ensure the safety and soundness – the continued viability – of the banking system, although it appears

increasingly to be expanding to include *non*-banking entities. Borrowing the very apt observation Representative Garrett made in a recent speech:

> "In the securities markets ... the Fed's safety and soundness, or 'no risk' mandate, simply doesn't fit. After all, investors in the securities markets can only make worthwhile returns to the extent they are willing to risk their money on companies that may or may not succeed."[6]

There is nothing in the Fed's 100-year history that even begins to suggest that applying prudential standards to capital markets participants would be a benefit – *or* that the Fed would in any sense be an effective capital markets regulator. It's just not what the Fed does.

Let me pause here to acknowledge, with Commissioner Dan Gallagher of the SEC, that it doesn't take an SEC Commissioner to explain the difference between deposits and investments. Still, he has noted, "when it comes to setting capital requirements, bank regulators seem increasingly determined to seek a one-size-fits-all regulatory construct for financial institutions."[7] But again, and as many have stressed, banks and investment funds are fundamentally different.

So, whatever the wisdom of designating any *bank* a SIFI and subjecting it to whatever additional capital standards or other constraints the Fed may devise in the exercise of its prudential regulation mandate, the question is why would *anyone* do the same for investment funds – *or*, for that matter, insurance companies? Let me hazard some possible answers.

First, section 113 of Dodd-Frank sets that out as the prescribed solution, thereby *making* it a good idea. And, to the extent that Dodd-Frank has been pre-sold as having solved the 2008-2009 financial crisis, its supporters have stressed the importance of implementing it fully and uncritically. There is a sort of book club mentality at work here – a sense that those in the charmed circle have figured out what was wrong and that all the benighted others should get out of the way of the prescribed solution – regardless of whether those others are independent expert agencies. Indeed, it is fair to say that Secretary Geithner's new book carries hints of that perspective.[8]

Second, one can identify a longstanding Fed and Treasury desire to bring mutual funds under the Fed's prudential regulation umbrella. Perhaps this is due to

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[6] Rep. Scott Garrett, Chairman, Capital Markets Subcommittee, House Committee on Financial Services, Keynote address, AEI Lunch Conference on the Designation of SIFIs by FSOC (May 6, 2014).

[7] Commissioner Daniel M. Gallagher, Remarks given at the Institute of International Bankers 25th Annual Washington Conference, March 3, 2014, available at: http://www.sec.gov/News/Speech/Detail/Speech/1370540869879#.U3TKMl6VglI.

[8] Timothy F. Geithner, Stress Test – Reflections on Financial Crises (2014).

their being fairly straightforward cash investments so, in that one, very limited sense, comparable to bank deposits. Imposing capital requirements and fees would raise funds for other regulatory purposes – for example, to help bail out financial institutions that are not viable. Forget the moral hazard.

Third, to the extent that implementing Dodd-Frank quickly and fully is seen as a *political* imperative, putting a dent in the fender of the largest mutual funds would, arguably, be a small thing. After all, the thinking goes, they can afford it (never mind that it's really the *investors* who will pay). And, in any event, under this rationale, whatever money is raised from whomever could perhaps be used to promote the stability of the financial system as a whole. But there's more: It would serve to vindicate the otherwise useless and sophomoric Office of Financial Research report of September 2013.[9] Well, if *that's* your motivation – if even ill-informed change is inherently good – then no amount of data or common sense need change your mind.

Fourth, the Financial Stability Board is well on its way to promulgating an international methodology for designating "Global-SIFIs" – a completely non-transparent effort that has prompted a torrent of concerned expert commentary.[10] Once final, FSB member states are, as a practical matter, very likely to see it as their obligation to implement the FSB standards. In the United States, that will involve, at a minimum, action by the SEC and perhaps other independent agencies – conceivably the CFTC, but certainly the Fed itself. And while the FSOC's ability to compel independent agencies to ratify its prefabricated policy outcomes is still very much in doubt, there can be little doubt that the current FSOC would, in fact, designate non-bank SIFIs in a manner consistent with the FSB's new methodology, whatever it may turn out to be.[11] This would, of course, call into question the integrity of the FSOC's own designation methodology and process, to the extent that they are ostensibly different from those of the FSB.

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[9] *See*, Office of Financial Research report, "Asset Management and Financial Stability," reprinted at: http://www.treasury.gov/initiatives/ofr/research/Documents/OFR_AMFS_FINAL.pdf. This is in no sense a partisan criticism. *See, e.g.*, singeing assessments of the OFR Report in letter to The Hon. Jacob Lew from Senators Kirk, Toomey, Moran, Carper, and McCaskill (Jan. 23, 2014), reprinted at: http://www.sec.gov/comments/am-1/am1-36.pdf. *See also* SEC Commissioner Aguilar's recent speech, "Taking an Informed Approach to Issues Facing the Mutual Fund Industry" (April 2, 2014), reprinted at: http://www.sec.gov/News/Speech/Detail/Speech/1370541390232#.U20IEV6ViCc, and Senator Mark Warner's recent letter to The Hon. Jacob Lew (May 9, 2014) ("report issued by OFR last September ... has come under considerable scrutiny").

[10] *See* comments on FSB's draft designation methodology reprinted at: https://www.financialstabilityboard.org/publications/r_140423.htm.

[11] These and related concerns are the subject of a May 9, 2014 letter from the Chairman and each Subcommittee Chairman of the House Financial Services Committee objecting to the non-transparency of the FSB and FSOC designation processes and requesting relevant documents from the Department of the Treasury, The Federal Reserve, and the SEC; *see*: http://financialservices.house.gov/uploadedfiles/05-09-14_jh-letter.pdf.

Finally, under section 113 of Dodd-Frank, SIFI designation is the height of the FSOC's mission, notwithstanding that it is easy to argue that FSOC designation of investment funds as SIFIs stems from a fundamental misunderstanding of their nature. To the proverbial policy hammer, after all, everything is a nail.

So why *not*? Well, it all comes down to this. Investment funds and banks are engaged in very different businesses that pose vastly divergent risks both to themselves and to the financial system as a whole. Apples are *not*, in *fact*, oranges, regardless of how they are described. Treating them the same is misguided. As to investment funds, it would be to impose costs without corresponding benefits. It would penalize efficiency by imposing arbitrary new costs disproportionately on the most efficient, low-cost funds – which correlate closely to the largest funds. The effect would be to introduce a wholly arbitrary and ill-founded *dis*incentive to cost-minimization *throughout* the industry – with the assured result that investors in funds both large and small would, for different reasons, surely bear higher costs and suffer correspondingly lower returns on their fund investments in the future.[12]

Indeed, homogenized prudential regulation of large, albeit dissimilar, institutions in the financial services industry could have the effect of increasing, rather than reducing, aggregate systemic risk. Those similarly regulated institutions would then be susceptible to the same shocks and more likely to behave similarly in the face of the same market events and behaviors. Is that not one of the lessons of 2007-2008? Heterogeneity in the financial services industry, as in genetics, is a systemically healthy feature.

Moreover, because the largest investment funds are all U.S.-based, any added capital charges and fees the Fed might elect to impose in the name of safeguarding those funds and ensuring the financial system's safety and soundness would, in fact, amount to a competitive disadvantage to the competitiveness of U.S. funds abroad. That would be a classic "own-goal," even if it assuaged the geo-commercial consciences of those who find it awkward that the 14 largest mutual funds are all American.

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And what could the individual investor saving for retirement reap from this situation? First, higher costs and lower returns. Mutual funds don't hold or, generally, raise capital. Were the Fed to impose capital requirements on SIFI-designated funds, investors – ordinary individual investors who are saving for retirement through their 401(k) plan or for a down payment – would have to pony up. The same would be true as to any fees imposed, just as it would were funds to

[12] For a recent attempt at calculating these costs to investors, *see* D. Holtz-Eakin & S. Thallam, *"The Investor Cost of Designating Investment Funds as Systemically Important Financial Institutions"* (May 15, 2014), at: http://americanactionforum.org/research/the-investor-cost-of-designating-investment-funds-as-systemically-important.

seek to raise capital some other way. Likewise, if capital requirements were imposed on fund advisers, investors would ultimately pay in the form of higher fees or decreased choice. The higher fees could cause investors to withdraw their money from funds managed by SIFI-designated advisers, which could lead to the advisers dropping below the threshold that caused them to be designated in the first place. Talk about circularity.

Second, even non-SIFI investment funds would operate in a less cost-competitive environment. Higher costs for the largest U.S. funds, whose costs tend to be lower per dollar invested than smaller funds, would reduce the incentive to smaller, relatively higher cost funds to minimize their costs. Once again, investors would lose – again with no demonstrable advantage either to fund or financial system.

Third, the Federal Reserve could constrain investors' ability to redeem their shares on demand. The Fed could impose a delay on the effectiveness of an investor's redemption decision or elect to require fund managers to remain in positions they would otherwise have elected to exit. Regardless of fund or investor interests, SIFI-fund managers could be forced to finance banks or other counterparties; remain exposed to particular markets; avoid exposure to specified issuers; and to hold cash or cash equivalents. What would this do to risk management or even to liquidity in the market? How would market participants price in this uncertainty regarding the potential disposition of securities? If anything, this uncertainty would make markets *more* unstable and much more unfair for the average investor in troublesome times.

All of this would be novel and none of it would provide any advantage to the fund's investors. Indeed, such Fed impositions would likely force a conflict with the fund manager's fiduciary duties to the fund in question. Because investors in mutual funds, in particular, tend to hold their shares for the long-term and to purchase additional shares through all phases of market cycles, a fund is very unlikely to be subject to a general run and, short of that, would be highly likely to be able to meet redemption requests as usual. That was, in any event, true during the 2008-09 financial crisis – the most recent serious test to the system.

Fourth, investors in sound funds could find their funds subject to demands to support failing banks – an entirely new and unnecessary phenomenon – think of it as an investor-funded "TARPs-are-us." So sure, one could argue that U.S. taxpayers were off the hook for bailouts, but it would be the unfortunate investors in SIFI funds – taxpayers all – whose returns would be subjected to the risk of supporting too-big-to-fail financial institutions.

That would be more tolerable were it not for the fact that investment funds are wound up and leave the business regularly, with *no* systemic consequences and *no* FDIC resolution process. During 2012 alone, 296 U.S. mutual funds were liquidated, following an orderly process involving fund manager and board decision,

approval of a plan of liquidation, payment of the fund's debts and obligations, conversion of portfolio securities to cash and payment of the proceeds to the fund's investors, followed by filing terminal financial reports and deregistration.[13] Because of the nature of the investor's agreement with his or her fund, there is simply no need for a "bail out," nor are such funds "interconnected" with other financial institutions in any way that would impose an unsustainable burden on them. Once again, we see new costs without corresponding benefits.

It is worth stressing also that investment funds are, overwhelmingly *providers* of capital. Mutual funds, in particular, tend to carry little or no leverage. Instead, regulated investment funds generally hold long equity and debt positions through which they help capitalize companies, governments, and central banks. In sum, a mutual fund does not transmit, but *bears* counterparty risk. To that extent, at least, mutual funds are the very opposite of the sort of entity enhanced Fed supervision was designed to support pursuant to a SIFI designation.

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Much the same objections could be made to FSOC designation of large insurance companies as SIFIs. In case you missed them, I note with great concern the pointed comments that FSOC's two insurance experts made in dissenting from the FSOC's designation of Prudential Financial as a SIFI. The FSOC's non-voting State Insurance Commissioner Representative, John Huff, stressed that "[i]nsurance is not the same as a banking product" and that FSOC's designation decision "inappropriately applies bank-like concepts to insurance products and their regulation, rendering the rationale for designation flawed, insufficient, and unsupportable."[14] Similarly, the FSOC's independent insurance expert, Roy Woodall, noted that the grounds for FSOC's determination "are simply not reasonable or defensible." He continued:

> "No empirical evidence is presented; no data is reviewed; no models are put forward. There is simply no support to link Prudential's material financial distress to *severe* consequences to markets leading to *significant* economic damage."[15]

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[13] *See* figures in App. E to ICI's April 7, 2014 letter to the Secretariat of the Financial Stability Board, at pp. E-1 - E-2 (ICI data), reprinted at: http://www.ici.org/pdf/14_ici_fsb_gsifi_ltr.pdf.

[14] View of Director John Huff, FSOC State Insurance Commissioner Representative (Sept. 19, 2013), reprinted at: http://www.treasury.gov/initiatives/fsoc/council-meetings/Documents/September%2019%202013%20Notational%20Vote.pdf.

[15] Dissent of Roy Woodall, the FSOC's "Independent Member having Insurance Expertise" (Sept. 19, 2013), reprinted at: http://www.treasury.gov/initiatives/fsoc/council-meetings/Documents/September%2019%202013%20Notational%20Vote.pdf.

If FSOC's cavalier treatment of the insurance industry is any precedent, we should all be extremely concerned that equally misguided and uninformed treatment of regulated investment funds – notably, mutual funds – is soon to follow.

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I cannot but conclude that the FSOC's moves to designate regulated investment funds as SIFIs are similarly without analytic foundation. Certainly, there is nothing in last September's self-serving OFR report[16] to suggest otherwise. Mr. Woodall added a further point that heightens my concerns, noting that FSOC had failed to make any recommendation to the primary financial regulatory agencies[17] or to the Federal Reserve under the FSOC's own Interpretive Guidance.[18]

Meanwhile, investment funds are thoroughly regulated by the SEC. Chair White, in fact, recently made that point while acknowledging, in response to your questions, Mr. Chairman, that the SEC has all the tools it needs to regulate investment funds.[19] That certainly was my view while an SEC Commissioner. Further, I – and a large number of other former bank and capital markets regulators who signed an open letter to the *Wall Street Journal* in December[20] – endorse a caveat Chair White made earlier this year; she pointed out that:

> "We want to avoid a rigidly uniform regulatory approach solely defined by the safety and soundness standard that may be more appropriate for banking institutions."[21]

True. FSOC's apparent disregard for the congressionally established expert independent regulator of the mutual fund industry in favor of its own Star Chamber of politically unaccountable agency heads and Administration appointees is, in my view, exceedingly unwise.

So my bottom line this morning is two-tiered: First, I strongly question whether it is even possible to make any sense of subjecting regulated investment funds to the Fed's prudential supervision, complete with capital requirements. Second, I would like to join – if I may, Mr. Chairman – in the plea you made to

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16 Office of Financial Research report, *"Asset Management and Financial Stability,"* reprinted at: http://www.treasury.gov/initiatives/ofr/research/Documents/OFR_AMFS_FINAL.pdf.

17 Citing Dodd-Frank sec. 112(k).

18 12 C.F.R. pt. 1310, app. A (2013).

19 *See* transcription of Hensarling-White exchange at April 29, 2014 hearing of the House Financial Services Committee (*"Oversight of the SEC's Agenda, Operations, and FY 2015 Budget Request"*), at: http://www.ici.org/viewpoints/view_14_house_sec_hearing.

20 Letter to the Editor, *"Don't Regulate Asset Managers as if They Were Banks,"* The Wall Street Journal, Dec. 17, 2013 (sixteen signatories), reprinted at: http://online.wsj.com/news/articles/SB10001424052702303932504579256681029347954.

21 Chair Mary Jo White, *Chairman's Address at SEC Speaks 2014* (Feb. 21, 2014), reprinted at: http://www.sec.gov/News/Speech/Detail/Speech/1370540822127#.U20ZrV6ViCc.

Secretary Lew at the Committee's hearing earlier this month – that the FSOC "cease and desist" from making further SIFI designations until the Committee has had an opportunity to study the matter further.[22] That, surely, is an eminently reasonable request – indeed, the very least one could ask given the major issues and enormous potential consequences entailed by proceeding further with non-bank SIFI designations.

Thank you – and I look forward to any questions the Committee may have.

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[22] *See* House Committee on Financial Services video recording of Hearing, *"The Annual Testimony of the Secretary of the Treasury on the State of the International Financial System"* (May 8, 2014), at: https://www.youtube.com/watch?v=aju2Uz_ZNbY; *see also* related Committee Press Release, at: http://financialservices.house.gov/news/documentsingle.aspx?DocumentID=379369.

Testimony of Michael S. Barr
Professor of Law
University of Michigan Law School
Before the House Financial Services Committee
Hearing on the Financial Stability Oversight Council
May 20, 2014

Chairman Hensarling, Ranking Member Waters, I am pleased to appear before you today to discuss the key role of the Financial Stability Oversight Council in reducing risks to the financial system.

In 2008, the United States plunged into a severe financial crisis that shuttered American businesses, and cost millions of households their jobs, their homes and their livelihoods. The crisis was rooted in unconstrained excesses and prolonged complacency in major financial capitals around the globe. The crisis demanded a strong regulatory response as well as fundamental changes in financial institution management and oversight.

The Dodd-Frank Act created the authority to regulate Wall Street firms that pose a threat to financial stability, without regard to their corporate form, and to bring shadow banking into the daylight; to wind down major firms in the event of a crisis, without feeding a panic or putting taxpayers on the hook; to attack regulatory arbitrage, restrict risky activities, regulate short-term funding markets, and beef up banking supervision; to require central clearing and exchange trading of standardized derivatives, and capital, margin and transparency throughout the market; to improve investor protections; and to establish a new Consumer Financial Protection Bureau (CFPB) to look out for the interests of American households.

The Act established a Financial Stability Oversight Council with authority to designate systemically important firms and financial market utilities for heightened prudential oversight by the Federal Reserve; to recommend that member agencies put in place higher prudential standards when warranted; and to look out for risks across the financial system. The Council is aided in its task by its own staff, the staff of member agencies, and the independent Office of Financial Research, which has its own duty to standardize and collect data and to examine risks across the financial system.

One of the major problems in the lead up to the financial crisis was that there was not a single, uniform system of supervision and capital rules for major financial institutions. The federal financial regulatory system that existed prior to the Dodd-Frank Act developed in the context of the banking system of the 1930s. Major financial firms were regulated according to their formal labels – as banks, thrifts, investment banks, insurance companies, and the like—rather than according to what they actually did. An entity that called itself a "bank" faced tougher regulation, more stringent capital requirements, and more robust supervision than one that called itself an "investment bank." Risk migrated to the less well-regulated parts of the system, and leverage grew to dangerous levels.

The designation of systemically important financial institutions (SIFIs) is a cornerstone of the Dodd-Frank Act. A key goal of reform was to create a system of supervision that ensured that if an institution posed a risk to the financial system, it would be regulated, supervised, and have capital requirements that reflected its risk, regardless of its corporate form. To do this, the Dodd-Frank Act established a process through which the largest and most interconnected financial firms could be designated as systemically important financial institutions and then supervised regulated by the Federal Reserve. The Council has developed detailed rules, interpretive guidance, and a hearing process, which goes beyond the procedural requirements of the Act, and including extensive engagement with the affected firms, to implement the designation process outlined in Dodd-Frank. The existing rules provide for a sound deliberative process; protection of confidential and proprietary information; and meaningful and timely participation by affected firms. The Council has begun designating firms under this authority.

Critics of designation contend that it fosters "too big to fail," but the opposite is the case. Regulating systemically important firms reduces the risk that failure of such a firm could destabilize the financial system and harm the real economy. It provides for robust supervision and capital requirements in advance, to reduce the risks of failure, and it provides for a mechanism to wind down such a firm in the event of crisis, without exposing taxpayers or the real economy to the risks of their failure.

Other critics argue that the FSOC should be more beholden to the regulatory agencies that are its members, but again, the opposite is true: Congress wisely provided for its voting members, all of whom are confirmed by the Senate, to participate based on their individual assessments of risks in the financial system, not based on the position of their individual agencies, however comprised. Members must also individually attest to their assessments in the FSOC's annual reports. The FSOC, moreover, has the duty to call on member agencies to raise their prudential standards when appropriate, and member agencies must respond publicly and report to Congress if they fail to act. If anything, the FSOC's powers should be strengthened, so that fragmentation in the financial regulatory system does not expose the United States to enormous risk, as it did in the past.

Some critics contend that certain types of firms in certain industries or over certain sizes should be categorically walled off from heightened prudential supervision, but such steps will expose the United States to the very risks we faced in the lead up to the last devastating crisis. The failure of firms of diverse types and diverse sizes at many points in even very recent memory—from Lehman and AIG to Long Term Capital Management—suggest that blindspots in the system should at the very least not be intentionally chosen in advance by the Congress. The way to deal with the diversity of sizes and types of institutions that might be subject to supervision by the Federal Reserve is to develop regulation, oversight and capital requirements that are graduated and tailored to the types of risks that such firms might pose to the financial system. FSOC and member agencies also have other regulatory tools available with respect to risks in the system for firms not designated as SIFIs, including increased data collection and transparency, collateral and margin rules for transactions, operational and client safeguards, risk management standards, capital requirements, or other measures.

Lastly, some critics complain that the FSOC's work is too tied to global reforms by bodies such as the Financial Stability Board (FSB). But global coordination is essential to making the financial system safe for the United States, as well as the global economy. The United States has led the way on global reforms, including robust capital rules, regulation of derivatives, and effective resolution authorities. These global efforts, including designations by the FSB, are not binding on the United States. Rather, the FSOC, and U.S. regulators, make independent regulatory judgments about domestic implementation based on U.S. law. The FSB itself has become more transparent over time, adopting notice and comment procedures, for example, but it could do more to put in the place the kind of protections that the FSOC has established domestically.[1]

Significant progress has been made in making the financial system safer, fairer and better focused on serving households, businesses and the real economy. The new CFPB has been built and is helping to make the marketplace level and fair. New rules governing derivatives transactions have largely been proposed. Resolution authority and improvements to supervision are being put in place. The Financial Stability Oversight Council has begun designating non-bank firms for heightened supervision and at the end of last year regulators finalized the Volcker Rule. These are important achievements. Now is not the time to weaken the system, but to stay strong on the path of reform.

[1] *See* Michael S. Barr, Who's In Charge of Global Finance, Georgetown Journal of International Law (forthcoming 2014).

INVESTMENT
COMPANY
INSTITUTE

STATEMENT OF

F. WILLIAM McNABB III
CHAIRMAN AND CHIEF EXECUTIVE OFFICER
THE VANGUARD GROUP, INC.

ON BEHALF OF THE

INVESTMENT COMPANY INSTITUTE

BEFORE THE

COMMITTEE ON FINANCIAL SERVICES
U.S. HOUSE OF REPRESENTATIVES

ON

EXAMINING THE DANGERS OF THE FSOC'S DESIGNATION PROCESS AND ITS IMPACT ON THE U.S. FINANCIAL SYSTEM

MAY 20, 2014

EXECUTIVE SUMMARY

- Operating under a remarkably comprehensive regulatory framework, U.S. registered investment companies ("funds" or, where appropriate, "mutual funds") help over 90 million investors achieve their most important financial goals. That regulatory framework, which serves both to protect investors and to mitigate risks to the financial system, again proved its worth during the global financial crisis.

- ICI and its members support appropriate regulation to ensure the resiliency and vibrancy of the global financial system. ICI is deeply troubled, however, by an ongoing process pointing to the possible designation of funds or their managers for enhanced prudential regulation and consolidated supervision by the Federal Reserve Board ("SIFI designation").

- A focus on asset management by the Financial Stability Oversight Council in the U.S. and the Financial Stability Board globally raises the prospect that the FSOC, in the name of promoting financial stability, may seek to exercise its SIFI designation authority in a manner far broader than Congress intended and that sweeps beyond any demonstrably "systemic" risks.

- These efforts could result in extending the Federal Reserve's supervisory authority to capital markets-based businesses that are beyond its areas of expertise. And they could lead to application of bank regulatory standards to funds or their managers—entirely out of keeping with the way in which these funds and their managers are structured, operated and currently regulated and with the expectations of investors and the capital markets.

- An objective assessment of the asset management industry must begin with a clear understanding of the fundamental distinctions between asset management and banking, including that asset managers act as agents, not principals. It is difficult to conceive of a situation in which a fund manager's financial distress or activities could raise systemic concerns, given the manager's agency role and the fact that economic exposures are those of each individual fund.

- SIFI designation of funds is equally unwarranted. Mutual funds use little to no leverage, and funds do not experience "financial distress" that can threaten financial stability. And history demonstrates that stock and bond mutual funds do not experience heavy redemptions even in periods of market stress. Finally, fund structure and regulation limit risk and risk transmission.

- Designation would be harmful to funds and their investors. A designated fund would be subject to bank-style prudential regulation—including capital and liquidity requirements—and to new fees and assessments, possibly including assessments to help shoulder the costs of "bailing out" a large, failing financial institution. Federal Reserve supervision also could come into conflict with a fund manager's fiduciary duty to act in the best interests of the fund. Designated funds would face higher costs, making them more expensive for investors and less competitive.

- If regulators believe specific activities or practices pose risks to the market or to the financial system, they should use their considerable rulemaking authority to address those risks through activity-based regulation. In the case of activities or practices involving the capital markets, the Securities and Exchange Commission should drive the process for identifying issues and considering appropriate solutions.

I. INTRODUCTION

My name is Bill McNabb. I am chairman and chief executive officer of Vanguard, one of the world's largest mutual fund complexes. Vanguard is a family of more than 160 mutual funds holding assets of nearly $3 trillion. Vanguard's core purpose is to take a stand for all investors, treat them fairly, and give them the best chance for investment success.

In this spirit, and in my capacity as chairman of the board of governors of the Investment Company Institute ("ICI"), I am pleased to appear before the Committee today to discuss the FSOC designation process and its implications for registered investment companies ("funds") and their investors. ICI's membership includes U.S. mutual funds, closed-end funds, exchange-traded funds and unit investment trusts with $16.8 trillion in assets. ICI seeks to encourage adherence to high ethical standards, promote public understanding, and otherwise advance the interests of funds, their investors, directors, and managers.

Over 90 million investors depend on funds in seeking to achieve their most important financial goals, such as saving for college, purchasing a home, or providing for a secure retirement. Funds and their managers operate under a remarkably comprehensive framework of regulation, including the Investment Company Act of 1940 ("Investment Company Act") and Investment Advisers Act of 1940. That framework has been enhanced over the years by Congress and the Securities and Exchange Commission ("SEC"), the primary fund regulator. The framework's major features—agency-based asset management, strict limits on leverage, daily mark-to-market valuation, exceptional transparency, and strong governance, among others—again proved their worth to investors during the global financial crisis. Notably, the regulatory framework serves both to protect investors and to mitigate risks to the financial system.

Over the last several years, ICI has actively supported U.S. and global efforts to address the abuses and excessive risk taking highlighted by the global financial crisis and to bolster areas of insufficient regulation, such as with respect to the OTC derivatives markets. As both investors in the capital markets and issuers of securities, ICI members support appropriate regulation to ensure the resiliency and vibrancy of the global financial system.

Nevertheless, ICI is deeply troubled by the process being pursued by the Financial Stability Oversight Council ("FSOC")—and a parallel process underway in the global arena that is being coordinated by the Financial Stability Board ("FSB")[1]—pointing to the possible designation of funds or

[1] The Financial Stability Board was established by the G20 "to coordinate at the international level the work of national financial authorities and international standard setting bodies and to develop and promote the implementation of effective regulatory, supervisory and other financial sector policies." *See* http://www.financialstabilityboard.org/about/overview.htm. The U.S. members of the FSB are the U.S. Treasury Department, the Federal Reserve Board, and the Securities and Exchange Commission.

their managers for enhanced prudential regulation and consolidated supervision by the Federal Reserve Board ("Federal Reserve"). The Dodd-Frank Wall Street Reform and Consumer Protection Act authorizes the FSOC to designate nonbank financial companies for this purpose—commonly referred to as "SIFI" (systemically important financial institution) designation. But the design of that law suggests that the use of SIFI designation should be reserved for *rare and compelling* cases—*i.e.*, where regulators have determined, on the basis of a thorough and reasoned analysis, that a specific company poses significant risks to financial system stability that cannot otherwise be adequately addressed through enhancements to existing regulation or by other regulatory authorities.

We have become increasingly concerned that the FSOC, in the name of promoting financial stability, may seek to exercise its SIFI designation authority in a manner far broader than Congress intended and that sweeps beyond any demonstrably "systemic" risks. A September 2013 report issued by the Treasury Department's Office of Financial Research ("OFR") and a January 2014 FSB consultation paper set forth improbable risks to U.S. or global financial stability that funds, their managers, or asset management activities could pose. Recent press reports have indicated that the FSOC is evaluating at least two firms, each of which has a large asset management business, for possible designation. If the FSOC continues down this path, it could result in extension of the Federal Reserve's supervisory authority to companies whose business is rooted in the capital markets and which the Federal Reserve does not have the expertise to regulate. And it could mean the application of bank regulatory standards that are entirely out of keeping with the way in which funds and their managers are structured, operated and currently regulated and with the expectations of investors and the capital markets.

We are not alone in raising concerns. Members of Congress in both parties, including members of this Committee and its Chairman, have expressed concerns in letters to senior government officials and during Committee hearings.[2]

In Section II below, we highlight several ways in which asset management (and, more particularly, funds and their managers) are fundamentally different from banking. Section III explains why SIFI designation of a fund manager is unwarranted, and why even the very largest funds likewise are not SIFIs. In Section IV, we discuss the investor harm and market distortion that would stem from such a SIFI designation. Finally, in Section V, we explain why activity-based regulation is a better

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[2] *See, e.g.*, Letter to The Honorable Jacob Lew, Chairman, FSOC; The Honorable Janet Yellen, Chair, The Federal Reserve System; and The Honorable Mary Jo White, Chair, SEC, from Rep. Jeb Hensarling (R-TX), Chairman, House Financial Services Committee, and the respective Subcommittee Chairmen, dated May 9, 2014; Letter to The Honorable Jacob Lew, Chairman, FSOC, from Sen. Mark Warner (D-VA), dated May 9, 2014; Letter to The Honorable Jacob Lew, Chairman, FSOC, from Reps. Dennis Ross (R-FL) and John Delaney (D-MD) and 39 other members of the House Financial Services Committee, dated April 9, 2014; Letter to The Honorable Jacob Lew, Chairman, FSOC, from Sens. Mark Kirk (R-IL), Thomas Carper (D-DE) and others, dated January 23, 2014.

approach to addressing identified risks.[3] These points are discussed in greater detail in ICI's comment letters on the OFR study and the FSB consultation.[4]

II. ASSET MANAGEMENT IS FUNDAMENTALLY DIFFERENT FROM BANKING

As regulators examine the potential for systemic risk in the asset management sector, ICI is concerned that many of those involved in the process are predisposed to view the world through a banking lens and to think of financial activity conducted outside of banks as "shadow banking." Both the FSOC and the FSB are dominated by banking regulators. Prudential standards and other requirements imposed via SIFI designations are designed to mitigate bank-like risks. And OFR's Asset Management and Financial Stability report, which recognizes on its very first page that asset managers act as agents on behalf of their clients, loses sight of this characteristic in its analysis.

An objective, unbiased assessment of the asset management industry must begin with a clear understanding of how asset management differs from banking. Fundamental distinctions related to funds and their managers are outlined below, and discussed in more detail throughout this testimony.

- **In asset management, managers act as agents, not as principals. A fund and its investors, not the fund manager, bear the risk of the fund's investments.** Acting as agent, a fund manager manages the fund's portfolio pursuant to a written contract and in accord with the fund's investment objectives and policies as described in the fund's prospectus. Fund management fees compensate the manager for managing the fund as a fiduciary and agent and for providing ongoing services that the fund needs to operate. The manager does not own the fund's assets and it may not use those assets to benefit itself or any other fund. Investment gains and losses experienced by a fund are solely attributable to that fund and its investors.

- **In asset management, there is no need for capital requirements or "loss absorption."** Fund investors understand that portfolio results, positive or negative, belong to them alone and accept the risk that their investments may lose value. Unlike with bank deposits, the risk of loss is inherent in an investment, including an investment in a fund.

- **In asset management, there is no need for government bailouts.** The concept of public bailouts is inapposite to funds and their managers. If a fund's manager went bankrupt, the

[3] This testimony does not focus on issues specific to money market funds. As noted by the Office of Financial Research in its September 2013 report entitled "Asset Management and Financial Stability," money market funds have undergone major reforms since the financial crisis and additional reforms remain under active consideration at the SEC. We believe this is the most appropriate way to address any remaining concerns regulators may have regarding those funds. In no event would SIFI designation be necessary or appropriate for a money market fund.

[4] *See* Letter to the Secretariat of the FSB from Paul Schott Stevens, President & CEO, ICI, dated April 7, 2014, available at http://www.ici.org/pdf/14_ici_fsb_gsifi_ltr.pdf; Letter to Elizabeth M. Murphy, Secretary, SEC from Paul Schott Stevens, President & CEO, ICI, dated Nov. 1, 2013, available at http://www.ici.org/pdf/13_ici_ofr_asset_mgmt.pdf.

manager would have no access to the fund's assets, assets of any other funds it manages, or other client assets. There would be no expectation of government intervention to prop up the manager. The fund's board of directors would simply hire another asset management company to manage the fund. In the case of funds themselves, investors are not promised gains on their investment, or even a return of the principal amount they invested. As noted above, fund investors and the broader marketplace understand that all investment results—gains and losses, no matter how big or small—belong to the fund's investors on a *pro rata* basis. Indeed, many funds had sharp declines in value during the financial crisis (most have since recovered that lost value). But there was never any suggestion, expectation or need for the government to step in and "rescue" a fund.

- **In asset management, there is no need for resolution planning.** As noted above, a fund's board of directors has the ability to replace the fund's manager. And in the event of a fund closure, federal and state laws already provide a clear process for a fund to make a *pro rata* distribution to its investors and wind up its affairs under the oversight of the fund's board of directors. Funds thus have no need for bank-like "resolution planning," and regulators have no need for additional authority to protect against a fund's "disorderly failure."

III. SIFI DESIGNATION OF FUNDS OR THEIR MANAGERS IS UNWARRANTED

Under the Dodd-Frank Act, SIFI designation is contemplated only for nonbank financial companies whose "material financial distress," or whose activities, could threaten U.S. financial stability.[5] This standard is rooted in the actual experience of the global financial crisis, when the distress or disorderly failure of certain large, interconnected and highly leveraged financial institutions—banks, insurance companies and investment banks—required direct intervention by the U.S. government, and taxpayer bailouts, to repair the damage.

It is difficult to conceive of a situation in which a fund manager's financial distress or activities could give rise to systemic concerns. In providing investment management and other services to funds, the manager acts in an agency capacity. The economic exposures, the impact of any use of leverage, and the interconnections with counterparties are those of each individual fund—*not* of the fund manager.

So does that suggest SIFI designation might be better targeted to funds themselves? That is the direction in which the FSB appears to be heading. Its proposed threshold for identifying which funds to evaluate as potential global SIFIs is US$ 100 billion in assets—and only 14 funds worldwide meet

[5] Section 113(a) of the Dodd-Frank Act states that the FSOC may determine that a U.S. nonbank financial company shall be subject to Federal Reserve supervision and enhanced prudential standards if it determines that "material financial distress at the U.S. nonbank financial company, or the nature, scope, size, scale, concentration, interconnectedness, or mix of the activities of the [company], could pose a threat to the financial stability of the United States."

that threshold. All of them are U.S. funds. And where the FSB may lead, we fear, the FSOC may choose to follow.

But the answer to the question above—"might SIFI designation be better targeted to funds themselves?"—is emphatically, "no." There are several compelling reasons why even the largest funds are *not* SIFIs. Each of these reasons is briefly described below.

A. Mutual Funds Use Little to No Leverage

History amply demonstrates that companies that are highly leveraged pose greater risk to the financial system than those that are not. In past financial crises, leverage has played a key role because in times of strain it can act as a multiplier, turning small losses into larger ones and creating risks that can shake the system overall. When one highly leveraged firm holds the debt of another highly leveraged firm, losses can mount exponentially and spread quickly.

Former Federal Reserve Chairman Alan Greenspan is one of many authorities who have recognized the role of leverage as the fuel of financial crises. Emphasizing the central role of leverage in the 2008 financial crisis, Chairman Greenspan recently wrote:

> Subprime [mortgages] were indeed the toxic asset, but if they had been held by mutual funds or in 401(k)s, we would not have seen the serial contagion we did. ... It is not the toxic security that is critical, but the degree of leverage of the holders of the asset. ... In 2008, tangible capital on the part of many investment banks was around 3 percent of assets. That level of capital can disappear in hours, and it did. And the system imploded.[6]

Mutual funds, as Chairman Greenspan's remarks suggest, typically have little or no leverage. The maximum ratio of debt-to-assets allowed by law is 1-to-3, which translates into a maximum allowable leverage ratio of 1.5-to-1. Many mutual funds stay well below this maximum limit. In fact, the very largest U.S. funds—those in the FSB's sights—have an average leverage ratio of just 1.04-to-1. By contrast, the largest U.S. commercial banks on average have leverage ratios that are ten times higher.

B. Funds Do Not Experience "Financial Distress" That Can Threaten U.S. Financial Stability

The concept of "financial distress" has little relevance to funds. All investment results belong to a fund's investors on a *pro rata* basis. If a fund doubles in value, it is the investors who reap this reward. And if the fund plunges in value, it is the investors who absorb the impact of those losses.

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[6] Alan Greenspan, "How to Avoid Another Global Financial Crisis," *The American*, March 6, 2014, available at http://american.com/archive/2014/march/how-to-avoid-another-global-financial-crisis.

A fund will have thousands or perhaps millions of investors, with varying degrees of risk tolerance. Long-term investors, or those following a specific asset allocation strategy, will be much more willing to stay the course and maintain their investment in a fund whose NAV is declining. Investors with a lower tolerance for investment risk or a shorter investment horizon, on the other hand, may decide to sell their fund shares in order to seek to eliminate the prospect of further losses. It is worth noting that during the financial crisis and ensuing global recession, many funds experienced sharp declines in value, but as discussed below, only modest redemption activity. Now that asset prices have recovered from their recession lows, most of those funds have gained back that lost value—as have the investors who stayed the course.

Funds and fund managers do, of course, exit the business. In fact, hundreds of funds close or reorganize each year for a variety of reasons, including the inability to attract or maintain sufficient assets, mergers with funds offering duplicate or similar strategies, departures of key portfolio managers, or poor investment performance. When a mutual fund liquidates, it follows an established and orderly process to distribute its remaining assets *pro rata* to its investors and wind up its affairs, in accordance with provisions of the Investment Company Act and state law and under the oversight of the fund's board of directors. Thus, such funds have no need for bank-like "resolution planning," and regulators have no need for additional authority to cope with "disorderly failures" of these funds.

C. History Demonstrates That Stock and Bond Mutual Funds Do Not Experience Heavy Redemptions, Even in Periods of Market Stress

The OFR study on asset management and the FSB consultation on investment funds both posit that mutual funds (the shares of which are redeemable on a daily basis) could face the risk of large redemption requests in times of market stress, causing the sale of fund assets at depressed prices and transmitting risk to the broader financial system. Since the inception of mutual fund investing in the U.S. almost 75 years ago, the historical evidence is consistent and compelling: stock and bond funds have never faced such a scenario, not even during the global financial crisis of 2007-2008. Indeed, across a range of adverse market events and conditions, sales of stocks and bonds by mutual funds represent a modest share of overall market activity—a fact that reflects the nature today of their largely retail investor base and the long-term financial goals of most fund investors.

More than 95 percent of mutual fund shares are held by retail investors, and for many of them, saving for retirement is their primary investment goal. In addition, nearly 80 percent of those who invest in mutual funds outside of employer-based retirement accounts rely on the advice of a financial professional. This combination of retirement saving and the use of financial professionals leads investors to pursue investment strategies with an eye toward diversification and the long term. It should come as no surprise, therefore, that the volatility of flows into and out of stock mutual funds has steadily declined since the 1980s, coinciding with the growth of retirement assets and the use of mutual funds in retirement accounts.

This long-term focus of mutual fund investors, in our view, has two important implications for financial stability. First, redemption requests almost never rise to unmanageable levels for a mutual

fund, even during periods of severe financial stress. Second, even in those times of stress, investors are making new purchases of fund shares, and funds are continuously receiving dividend and interest income. A mutual fund can use these cash inflows to support redemptions, thus minimizing the fund's need to sell portfolio securities. For example, during September and October 2008—the height of the financial crisis—investors purchased $274 billion of equity mutual fund shares and $141 billion of bond mutual fund shares. In addition, during those two months stock funds reinvested $7 billion in dividend payments and bond funds reinvested nearly $11 billion. As a result, net outflows from stock funds (including reinvested dividends) amounted to only 2 percent of fund assets during September and October of 2008. For the same period, net outflows from bond funds amounted to only 1.8 percent of bond fund assets.

Another significant factor is the close correlation between investor activity in mutual fund shares and portfolio transactions by the fund manager. In the face of unexpected market events, fund managers generally are not selling portfolio assets into the market unless such sales are correlated to investor flows. This fact, taken together with the staying power of mutual fund investors as outlined above, means that even a large mutual fund is unlikely to face a situation in which it must liquidate its assets quickly.

Finally, we note that sales of portfolio assets by mutual funds do not impact overall market prices to any substantial degree. Even when portfolio managers do sell assets, these sales are small relative to the value of overall stock and bond market trading and place little, if any, additional downward pressure on securities prices. Importantly, during the financial crisis, domestic stock funds owned about 25 percent of U.S. stocks, but their gross stock sales—not offset by any purchases—represented less than 6 percent of market trading. If anything, funds had a dampening effect on market volatility during that period.

D. Fund Structure and Regulation Limit Risk and Risk Transmission

In addition to the agency capacity in which a fund manager acts, which was discussed above, structural features of funds have the effect of limiting risk and the transmission of risks. Most notably, each fund is a separate legal entity; its assets are separate and distinct from, and not available to claims by creditors of, other funds or the fund manager. Each fund has its own investment objectives, strategies, and policies. One fund's economic exposures will be different from another's and belong to it alone. Fund losses do not spread to other funds or to the manager.

Funds and their managers are comprehensively regulated under the Investment Company Act, other federal securities laws, and related SEC regulations. For mutual funds, these requirements are largely built around a defining feature of such funds—the ability of investors to redeem their shares daily at current value. Fund regulations also are designed to ensure that investors and other market participants have a clear understanding of a fund's investment strategy, holdings, and financial condition. In short, the regulatory regime for funds serves both to protect the interests of investors and to mitigate risk. The most salient of these requirements are as follows:

- **Daily mark-to-market valuation of the fund's assets.** Mutual funds must value all of their portfolio holdings on a daily basis, based on readily available market values. These values are used to calculate the fund's daily net asset value (NAV), which is the price used for all transactions in fund shares. This promotes market confidence, because investors, counterparties and others can understand easily the actual valuations of fund portfolios.

- **Liquidity to support redemptions.** At least 85 percent of a mutual fund's portfolio must be held in liquid securities. The SEC has determined that this liquidity standard should satisfactorily ensure a fund's ability to meet redemptions.

- **Leverage and borrowing limitations.** The Investment Company Act and related guidance limit the extent to which mutual funds can borrow or engage in other transactions involving leverage. As noted above, the maximum ratio of debt-to-assets allowed by law is 1-to-3, which translates into a maximum allowable leverage ratio of 1.5-to-1. A mutual fund must "cover" its future obligations by meeting enumerated asset coverage tests or, in certain cases, by segregating liquid assets on its books or maintaining offsetting positions.

- **Extensive disclosures.** Under the federal securities laws and applicable SEC regulations, mutual funds are subject to the most extensive disclosure requirements of any financial product. Mutual funds maintain an "evergreen" prospectus and provide robust public periodic reporting (including quarterly portfolio holdings) and audited financials. This high degree of transparency allows investors and other market participants a clear understanding of a fund's investment strategy, holdings and financial condition.

- **Simple, transparent structure.** Mutual funds are prohibited from issuing debt or preferred stock. They do not engage in off-balance sheet financing.

- **Diversified portfolios.** All mutual funds are required by the federal tax laws to be diversified. Generally speaking, the minimum diversification a fund could have is 25% of its assets in each of two issuers, and 5% of its assets in each of 10 additional issuers. If a fund elects to be diversified for purposes of the Investment Company Act (and most do), the requirements are more stringent—with respect to 75% of its portfolio, no more than 5% may be invested in any one issuer.

- **Restrictions on affiliated transactions.** The Investment Company Act contains strong and detailed prohibitions on transactions between a fund and affiliates such as the fund manager, the manager's corporate parent, or an entity under common control with the fund manager. These provisions are no less stringent than those contained in Sections 23A and B of the Federal Reserve Act. They also prevent most types of sponsor support, absent prior approval by the SEC on a case-by-case basis.

- **Custody protections.** All funds must maintain custody of fund assets (including any collateral posted by the fund) with eligible custodians, in order to safeguard fund assets from theft or misappropriation. Nearly all funds use a bank custodian for domestic securities, and the custody agreement is typically far more elaborate than the arrangements used for other bank clients. The benefits of this approach were highlighted following the collapse of Lehman Brothers, as mutual funds with such custody arrangements were able to take control of both their own collateral and the collateral posted by Lehman with far less difficulty than market participants with different custody arrangements.

- **Independent board oversight.** Funds are unique among investment products in that they are required by statute to have a board of directors with oversight responsibility for the fund's investment program, risk management and compliance, portfolio valuation and investment performance. In practice, more than four out of five fund boards have a significant majority of independent directors, who serve as "watchdogs" for the interests of fund investors. All fund directors are fiduciaries who must act in the best interest of the fund.

IV. SIFI DESIGNATION OF FUNDS WOULD HARM FUND INVESTORS AND DISTORT COMPETITION

Under the Dodd-Frank Act, nonbank SIFIs are subject to: (1) enhanced prudential standards, including capital and liquidity requirements; (2) assorted fees and assessments; and (3) Federal Reserve supervision. Exactly how some of these measures will be applied to any specific nonbank SIFI is not yet known. But it is indisputable that applying requirements designed to moderate bank-like risks to funds would be highly problematic for funds and harmful to their investors. Designated funds and their investors would bear higher, unnecessary costs and could be put on the hook to bail out failing institutions in the next financial crisis. Designation also could adversely affect the management of funds' portfolio investments and funds' ability to serve investors.

- **Capital requirements.** The Dodd-Frank Act subjects nonbank SIFIs to certain mandatory enhanced prudential standards and authorizes heightened standards in other areas. Most troubling is the prospect of capital requirements. One provision of the Dodd-Frank Act gives the Federal Reserve discretion in applying capital standards to nonbank SIFIs but senior Federal Reserve officials have indicated that another—known as the "Collins Amendment"—does not. As a result, the Federal Reserve would be compelled to hold a designated fund to the bank minimum capital requirement of 8 percent. Funds have neither the need for capital nor the ability to meet capital requirements. Their "capital" comes from investors who own fund shares and who fully accept that *they* will absorb the investment gains and losses experienced by the fund. Any mechanism for "loss absorption" would be inconsistent with funds' basic nature and purpose.

- **Liquidity requirements.** Depending on how the Federal Reserve implements liquidity requirements for nonbank SIFIs, a designated fund could be required to hold more cash or

cash-equivalent securities than the manager projected when establishing the fund's investment objectives and policies. This could impede the fund's ability to deliver returns its investors expect and render it less competitive.

- **Fees and assessments.** Nonbank SIFIs are subject to fees to defray the Federal Reserve's increased supervisory costs and to assessments to cover the expenses of the FSOC and the OFR. The Dodd-Frank Act also authorizes assessments if needed to reimburse the U.S. government for costs of resolving a distressed financial institution determined to be systemically important, such as a large bank holding company. As applied to funds, these fees and assessments are tantamount to taxes on fund investors. Particularly disturbing and ironic is the possibility that fund investors, many of whom are using funds to save for retirement, might be required to help shoulder the costs of a "bailout" of a large financial institution—under a provision that Congress enacted specifically for the purpose of *avoiding* burdening taxpayers with these costs.

- **Prudential supervision.** The Federal Reserve's prudential supervision could conflict with a fund's investment objectives and policies as described in the fund's prospectus and with the fiduciary duties of a fund's manager and board of directors to act in the best interests of the fund. In the interest of mitigating risks to the financial system, the Federal Reserve could impel a fund's manager to manage the fund's portfolio in a manner that the manager otherwise would not do, and that the manager may believe to be contrary to the best interests of fund investors and to its own fiduciary duties. For example, the Federal Reserve could pressure the fund to continue financing certain counterparties or not sell particular securities, avoid exposure to certain issuers, or maintain excess levels of cash or cash equivalents.

The increased costs associated with SIFI designation clearly would lead to higher expenses for fund investors—a cohort that has shown itself to be quite sensitive to costs. Consider the 14 funds with assets that exceed the FSB's proposed $100 billion threshold. They are highly efficient, relatively low-cost funds within their asset classes. Their expense ratios range from 76 basis points down to 3 basis points, with an asset-weighted average of 31 basis points. On that base, it would not take much in added fees, assessments, and capital costs to increase quite significantly the expenses borne by investors in these funds.

The costs and fund management implications of SIFI designation would make any designated fund less competitive and less attractive to investors. This, in turn, would distort competition in the fund marketplace and could limit investor choice.

Key financial regulatory officials have acknowledged the limitations of prudential regulation. For example, Federal Reserve Board Governor Daniel Tarullo has observed that "prudential standards

designed for regulation of bank-affiliated firms may not be as useful in mitigating risks posed by different forms of financial institutions."[7] Similarly, SEC Chair Mary Jo White recently stated:

> We also will continue to engage with other domestic and international regulators to ensure that the systemic risks to our interconnected financial systems are identified and addressed – but addressed in a way that takes into account the differences between prudential risks and those that are not. We want to avoid a rigidly uniform regulatory approach solely defined by the safety and soundness standard that may be more appropriate for banking institutions.[8]

We agree with these statements. Applying bank-oriented prudential regulation to funds is unwarranted and could severely impair the single best tool for individual investors saving for such financial goals as retirement or education.

V. ACTIVITY-BASED REGULATION IS A BETTER APPROACH TO ADDRESSING IDENTIFIED RISKS

As discussed above, funds and their managers simply do not pose the concerns that would warrant SIFI designation. Moreover, forcing certain individual funds into a bank regulatory mold through the imposition of prudential standards and Federal Reserve supervision would be wholly inappropriate and have harmful consequences for these funds and their investors. Instead, if regulators believe specific activities or practices pose risks to the market or to the financial system, ICI recommends that regulators use their considerable rulemaking authority to address those risks through activity-based regulation.

An activity-based approach offers several advantages. First, it starts with identified activities and practices that pose demonstrable risks. Second, it would follow regular rulemaking procedures such as open meetings, public notice and opportunities for comment. Third, targeting activities and practices will engage primary regulators who have deep experience and expertise with specific industries and markets. In the case of activities or practices involving the capital markets, the SEC should drive the process for identifying issues and considering appropriate solutions.

Indeed, the SEC is doing just that with respect to asset management. According to Chair White's recent comments before this Committee, the SEC already has the necessary authority to adequately regulate the industry. But it is taking additional steps to strengthen its oversight of asset managers and funds. The SEC's Division of Investment Management is working to expand its asset

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[7] *Regulating Systemic Risk,* Remarks by Daniel K. Tarullo, Member, Board of Governors of the Federal Reserve System, at the 2011 Credit Markets Symposium, Charlotte, N.C. (March 31, 2011), available at http://www.federalreserve.gov/newsevents/speech/tarullo20110331a.pdf

[8] *Remarks to the 2014 SEC Speaks Conference,* Mary Jo White, Chair, SEC (Feb. 21, 2014), available at http://www.sec.gov/News/Speech/Detail/Speech/1370540822127.

manager risk management oversight program, which includes developing a proposal for enhancing its collection of mutual fund data. The latter initiative is designed to provide the SEC with more timely and useful information about fund operations and portfolio holdings. ICI and its members are providing the SEC staff with industry expertise and practical information that we hope will help lead to requirements that measurably improve the SEC's ability to identify and monitor risks without imposing undue costs and burdens on funds and their investors.

In other areas, regulators have taken and are continuing to take actions to mitigate risk in the financial system or to make markets and market participants more resilient to future shocks. For example, securities lending and repurchase agreement transactions are currently the subject of specific regulatory efforts, with additional efforts on the horizon. Under Title VII of the Dodd-Frank Act, regulators have promulgated rules governing, among other things, initial and variation margin requirements for cleared and uncleared swaps and other terms central to counterparty and clearinghouse relationships. Once fully implemented, the Title VII regime will dramatically change the way swaps are traded, cleared and settled, to the benefit of both individual counterparties and the financial system generally.

In addition to these regulatory developments, ICI's Board of Governors has endorsed a voluntary initiative led by the Depository Trust & Clearing Corporation to shorten settlement cycles for a range of securities from trade date plus three days (T+3) to T+2. The voluntary move to a T+2 settlement cycle would reduce systemic, liquidity, and operational risks, promote better use of capital, and create significant process efficiencies for market participants—all changes that would benefit investors.

VI. CONCLUSION

I appreciate the opportunity to share these views with the Committee. ICI looks forward to continued engagement with Congress and regulators on issues relating to the fund industry and broader questions relating to U.S. financial stability.

STATEMENT OF EUGENE SCALIA
GIBSON, DUNN & CRUTCHER LLP
BEFORE THE
HOUSE COMMITTEE ON FINANCIAL SERVICES
REGARDING THE FINANCIAL STABILITY OVERSIGHT COUNCIL'S DESIGNATION OF SYSTEMICALLY IMPORTANT NONBANK FINANCIAL COMPANIES

May 20, 2014

Mr. Chairman and Members of the Committee:

Thank you for the opportunity to testify today on the important subject of the Financial Stability Oversight Council ("FSOC" or "the Council") and its performance of its responsibilities under the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act").[1] I speak to you today not as an expert on the financial system or bank supervision, but as a lawyer in private practice who deals regularly with questions of administrative law and procedure, including the performance of statutory responsibilities by financial regulatory agencies.

The responsibilities given to FSOC under the Dodd-Frank Act are important ones and, four years after passage of the Act, it is appropriate to evaluate how those responsibilities have been discharged. FSOC appears to be pursuing its mission with vigor. However, grounds for concern have emerged regarding the procedures FSOC employs and the substantive judgments it has rendered in designating nonbank financial institutions systemically important. I will focus my remarks today on these emerging areas of concern.

1. FSOC Fails To Provide Clear Standards And Guidance On What Poses Systemic Risk

FSOC's authority to designate a nonbank financial company as a systemically important financial institution ("SIFI") is conditioned on a determination that either (1) material financial

[1] Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (July 21, 2010).

distress at the nonbank financial company or (2) the nature, scope, size, scale, concentration, interconnectedness, or mix of the activities of the company could pose a threat to the financial stability of the United States.[2]

These thresholds—which set a high standard—are statutorily prescribed by Section 113 of the Dodd-Frank Act, which also sets forth 11 factors FSOC must consider in making its designation decisions. These factors include, among others, the extent of the company's leverage and off-balance sheet exposures; the company's relationships with other significant bank holding and nonbank financial companies; the company's importance as a source of credit for households, businesses, and state and local governments and as a source of liquidity for the American financial system; the extent to which the company's assets are managed rather than owned and whether ownership of assets under management is diffuse; the degree to which the company is already regulated by one or more primary financial regulatory agencies; and any other risk-related factors that FSOC deems appropriate.[3]

In addition to these statutory factors, FSOC has adopted regulations and interpretive guidance for prospective designees.[4] Among the regulatory criteria FSOC has said it will consider are the prospective designee's size, interconnectedness, substitutability, leverage, liquidity risk and maturity mismatch, and existing regulatory scrutiny.[5]

Unfortunately, FSOC's regulations and guidance have done little to give potentially regulated parties adequate notice of the legal standards that will be applied to them, and whether—in view of those standards—they are likely to be designated systemically important,

[2] *Id.* § 113(a)(1).

[3] *Id.* § 113(a)(2)(A)-(K).

[4] *See* 77 Fed. Reg. 21,637, 21,641 (Apr. 11, 2012).

[5] *Id.*

and what changes they could make in their structure and operations so that they are not designated. FSOC has not even defined "systemic risk," for example, or indicated what level of risk is sufficient to warrant designation, and how it will be ascertained. Parties know in general terms the factors FSOC has said it will consider, but not the relative weight those factors will be given, nor the "tipping point" for any individual factor, beyond which designation becomes more likely.

Even the process by which companies are considered for designation is exceptionally opaque. FSOC members make two crucial votes in designating a company a SIFI—a vote on a so-called proposed designation determination, and then the final designation determination. Although companies under consideration are able to submit evidence and argument prior to the preliminary designation, they have no apparent way of knowing whether or how those materials are presented to FSOC's voting members. They also have no assurance of notice of what *other* materials are presented to the voting members, much less of an opportunity to review those materials and to respond with their own analysis of the record on which voting members will make their decision. Instead, companies are kept in the dark until *after* the FSOC members have made a preliminary decision to designate them—at which point a company is effectively in the position of taking an "appeal" to the very people who ruled against it and will naturally be predisposed to ratify, rather than reverse, their own prior judgment.

Under some regulatory regimes, regulated parties are able to review past decisions by the agency to gain a better understanding of the standards that will be applied to them, but that is not the case with FSOC. I will speak in a moment about the lack of substantiation and analytic rigor in the Council's designation decisions to date; another problem (albeit a related one) is the lack of clarity and precision in those decisions. The designation decisions for American International

Group, Inc. ("AIG") and Prudential Financial, Inc. ("Prudential"), for example, refer to the applicable statutory and regulatory factors in only the most general terms, without the specificity, clarity, and concreteness necessary to apprise regulated parties of the relative weight given to the various factors, and where the "line is crossed" under any particular factor such that it begins to favor designation.[6]

What little can be discerned from FSOC's public designation determinations and regulatory activities suggests that the Council may be deviating from the statutory standards in Dodd-Frank. This is a trend that may bear monitoring by the Committee as FSOC continues to go about its business. In the publicly-available version of its Prudential designation decision, for example, FSOC provided no meaningful discussion of the *statutory* criteria for designation and provided little indication of the particular *statutory* factors that prompted FSOC to designate Prudential as systemically important.[7] And the controversial report on asset managers by the Office of Financial Research[8] suggests that FSOC may treat asset management as an activity that militates *in favor* of SIFI designation, whereas Section 113(a)(2)(F) of the Dodd-Frank Act

[6] *See* FSOC, "Basis for the Financial Stability Oversight Council's Final Determination Regarding Prudential Financial Inc.," at 5-6, 11-12 (Sept. 19, 2013) (stating that FSOC considered the 11 statutory considerations set out in the Dodd-Frank Act but discussing only the existing regulatory scrutiny factor in any detail) ("Prudential Designation"); *see also* FSOC, "Basis of the Financial Stability Oversight Council's Final Determination Regarding American International Group, Inc.," at 11-14 (July 8, 2013) (engaging in a general evaluation of the Dodd-Frank Act statutory factors without considering any specific thresholds or levels of risk) ("AIG Designation").

[7] *See* Prudential Designation at 5-6, 11-12.

[8] *See* Department of the Treasury, Office of Financial Research, "Asset Management and Financial Stability" (Sept. 2013); *see also* Sarah N. Lynch, *Memos Show SEC-Treasury Dispute Over 2013 Asset Management Study*, Reuters (Apr. 7, 2014), *available at* http://www.reuters.com/article/2014/04/07/sec-documents-assetmanagers-idUSL2N0MZ0UL20140407 (reporting that emails and memoranda obtained by a House investigative panel show that the SEC disagreed with some of the contents of the asset management report and had cautioned that the Office of Financial Research was overemphasizing money market funds and analyzing asset managers through "a bank lens").

indicates that asset management, as opposed to ownership of assets, should militate *against* designation.[9]

Market participants need fair notice of the legal standards that will be applied to them. Ultimately, constitutional due process requires this. FSOC has failed to provide this notice to date.

2. **FSOC's Designation Decisions To Date Are Thinly Reasoned And Unsupported By Substantial Evidence**

Under the Administrative Procedure Act ("APA") and well-established standards for agency decisionmaking, FSOC is required, among other things, to "examine the relevant data and articulate a satisfactory explanation for its action[,] including a rational connection between the facts found and the choice made."[10] FSOC's examination of the record must include cogent consideration of evidence that conflicts with its ultimate decision, as well as a reasoned explanation for rejecting that evidence.[11] And while Dodd-Frank does not expressly require FSOC to conduct cost-benefit analyses in its designation decisions, it would be arbitrary and capricious for FSOC to select a financial institution for heightened oversight based on predicted economic behavior and financial consequences, without a sound economic analysis to support its forecasts of market behaviors and financial effects.

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[9] *See* Dodd-Frank Act § 113(a)(2)(F) (FSOC must consider "the extent to which assets are managed rather than owned by the company, and the extent to which ownership of assets under management is diffuse").

[10] *Motor Vehicle Mfrs. Ass'n of U.S., Inc. v. State Farm Mut. Auto. Ins. Co.*, 463 U.S. 29, 43 (1983) (internal quotation marks omitted).

[11] *See Int'l Union, United Mine Workers of Am. v. Mine Safety & Health Admin.*, 626 F.3d 84, 93-94 (D.C. Cir. 2010); *see also Sw. Airlines Co. v. Transportation Sec. Admin.*, 650 F.3d 752, 759-60 (D.C. Cir. 2011).

FSOC's public designations to date fall far short of these standards.[12] Its public designation decision for Prudential is representative of the flaws in its designation decisions to date. The Prudential decision presupposes severe financial distress at Prudential—with no consideration at all whether there are indicia that such distress is likely to occur—and then relies on a series of broad, unsubstantiated assertions to conclude that "material financial distress at Prudential could pose a threat to the financial stability of the United States and that Prudential should be supervised by the Board of Governors and be subject to enhanced prudential standards."[13] Time and again, as to every risk factor considered, the Prudential decision postulates what "could" occur, and characterizes the resulting consequences as potentially "significant," without in any way estimating the *likelihood* of the event or the *magnitude* of its effects. In the words of a dissenting FSOC member, "[n]o empirical evidence is presented" in the decision regarding the effects of a Prudential failure on the broader economy, "no data is reviewed; no models put forward."[14] Peter Wallison has noted that the word "significant" is used 47 times in the 12-page decision,[15] without elaboration or quantification; "could" appears 87 times, divorced from any estimate of probability.

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[12] In the case of Prudential and perhaps other designation decisions, there is a separate, confidential decision that FSOC has declined to make available to the public. There is reason to believe that in these non-public versions of the decisions, the agency's reasoning and substantiation of its projections are no weightier than in the public versions. And of course, the public cannot draw guidance from secret decisional documents that the agency refuses to make available. This practice by FSOC is just one manifestation of the unusual opaqueness that characterizes Council proceedings.

[13] Prudential Designation at 12.

[14] Dissent of Roy S. Woodall, Jr., Independent Member with Insurance Expertise, to Prudential Designation ("Woodall Dissent"), at 6 (Sept. 18, 2013).

[15] Peter J. Wallison, "What the FSOC's Prudential Decision Tells Us About SIFI Designation" at 4 (AEI, March 2014).

The designation of Prudential purports to be based on a risk assessment, but a risk analysis that assesses neither the probability nor the magnitude of the event is not a risk assessment at all.

In making its projections, the Prudential decision also ignores countervailing evidence, or dismisses it with cursory and wholly unpersuasive rationales. FSOC acknowledged, for instance, that Prudential has the right to "defer payouts on a significant portion of policies with immediately payable cash surrender values" but asserted, without explanation or evidence, that Prudential "*could have* strong disincentives to invoke this option because of the negative signal invoking such a deferral could provide to counterparties, investors, and policyholders."[16] Yet the hypothetical scenario FSOC was addressing was one in which Prudential already was experiencing financial difficulties that—FSOC presupposed—were so serious and widely-known that large numbers of policy-holders were seeking to surrender their policies; the Council offered no explanation why a company *already* in the midst of such a crisis would be more concerned about potential "negative signaling" than taking the steps necessary to preserve its financial stability. Likewise, in its Prudential decision FSOC acknowledged the existence of state regulatory authorities, including supervisory colleges for insurance companies, but dismissed them without evaluating their efficacy on the ground that they do not possess "the *same* authorities to which nonbank financial companies would be subject if [FSOC] determines that such nonbank financial companies shall be subject to supervision by the Board of Governors."[17] While it is a truism that existing regulatory authorities are not "the same" as those that would apply in the event of designation, framing the issue in that manner ignores the central question

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[16] Prudential Designation at 2 (emphasis added).

[17] *Id.* at 11 (emphasis added).

whether those existing regulatory protections are *adequate* (or indeed whether they are superior because they have been designed over a period of years to address problems that arise at insurance companies particularly).

This sort of regulatory hauteur—which deems a state regulatory program insufficient because it is not "the same" as the federal government's—recently caused a regulation of the SEC to be vacated by the U.S. Court of Appeals for the District of Columbia Circuit.[18] Unsubstantiated speculation and *ipse dixit* fall well short of what the courts demand of federal agencies in litigation challenging agency decisionmaking as "arbitrary and capricious" under the APA.

FSOC's errors in the Prudential decision are compounded by its failure to apply the designation factors in a manner that respects the differences between banking and insurance, distinctions that should have been crucial to FSOC's evaluation of Prudential.[19] The Council's disregard for the facts and circumstances of the insurance sector was highlighted in the dissent by Roy S. Woodall, Jr., who holds the seat on FSOC reserved by statute for "an independent member . . . having insurance expertise,"[20] and is the only voting FSOC member with expertise in the industry. Mr. Woodall wrote that FSOC's "underlying analysis utilizes scenarios that are antithetical to a fundamental and seasoned understanding of the business of insurance, the insurance regulatory environment, and the state insurance company resolution and guaranty fund systems."[21] This is a serious criticism. (It has been echoed by others in the insurance sector.[22])

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[18] *Am. Equity Inv. Life Ins. v. SEC*, 613 F.3d 166, 178-79 (D.C. Cir. 2010).

[19] Dodd-Frank Act § 113(a)(2)(K).

[20] *Id.* § 111(b)(1).

[21] Woodall Dissent at 1.

[22] *See* Statement of Jim Donelon, NAIC President and Louisiana Insurance Commissioner (Sept. 20, 2013), *available at* http://www.naic.org/newsroom_statement_fsoc_prudential_designation.htm ("I am deeply troubled

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Particularly given Mr. Woodall's expertise in insurance and his statutorily-assigned role on the Council, his criticisms should have received a direct and substantial response in FSOC's decision—this is what a court reviewing the Prudential decision would have expected, I believe. The Council's decision to effectively ignore Mr. Woodall's critique is not consistent with reasoned decisionmaking under the APA.

In his dissent, Mr. Woodall suggested that the summary nature of FSOC's Prudential decision might be attributable in part to the possibility that Prudential's designation had been predetermined by the Financial Stability Board ("FSB"), the international body whose members include both the Federal Reserve ("Fed") and Treasury, and which had designated Prudential a "global systemically important insurer" before FSOC made its designation decision. The FSB decision had "overtaken the Council's own determination process" for Prudential, Mr. Woodall wrote; indeed, the international and domestic processes "may not be entirely separate and distinct."[23] If so, that is disturbing. The FSB is not a U.S. agency, does not apply and is not bound by the Dodd-Frank Act, and affords designation candidates no meaningful opportunity to represent their interests during its decisionmaking. By the terms of Dodd-Frank, the responsibilities of the voting members of FSOC are "nondelegable";[24] this unusual, explicit requirement demands their personal engagement, and is one of several reasons FSOC members

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by the implications of the Financial Stability Oversight Council's action designating Prudential as a systemically important financial institution. The justification for [FSOC's] designation [of Prudential] shows fundamental gaps in FSOC's understanding of the business of insurance or the regulatory regime that governs it. More disturbing is the unknown consequences of such a designation and the potential disruption in the insurance marketplace."); Statement of Sen. Ben Nelson, NAIC CEO (Sept. 19, 2013), *available at* http://www.naic.org/newsroom_statement_fsoc_prudential_designation.htm (in the aftermath of the Prudential designation decision, "[t]he NAIC . . . continue[s] to believe that traditional insurance activities do not pose a systemic threat to the financial system, and encourage[s] FSOC to focus on highly leveraged, thinly capitalized, or unregulated activities of non-banks as it exercises its authority.").

[23] Woodall Dissent at 9.

[24] Dodd-Frank Act § 113(a)(1).

may not allow their designation decisions to be front-run by a non-U.S. body that does not apply U.S. law or adhere to U.S. standards of due process.

Ultimately, FSOC's designation decisions to date do not reflect the analytic rigor that Congress and the courts require of administrative agencies in a matter of such significance. They exhibit no depth of analysis and are wholly lacking in the supporting empirical evidence that is required for agency decisions generally, and that is central to decisions whose very essence should be the assessment of financial data and economic evidence.

3. FSOC Has Not Given Sufficient Consideration To The Efficacy Of Other Regulatory Authorities

A persistent flaw in FSOC's designation decisions to date, and a principal concern in Mr. Woodall's dissent, is the Council's failure to give sufficient attention and weight to the existing regulatory scrutiny to which potential designees already are subject.[25] Numerous provisions of the Dodd-Frank Act make clear that Congress intended FSOC to pay close attention to other regulators' requirements and efforts, and not to give undue weight to the regulatory programs of the FSOC's members' agencies. Section 113(a)(2)(H) requires that FSOC consider existing regulations when determining whether to designate a company as systemically important. Section 113(g) directs FSOC to consult with a company's primary financial regulator when making any systemic significance determination. Section 169 of Dodd-Frank seeks to avoid duplication of regulatory standards, providing that the Fed "shall take any action" that it "deems appropriate to avoid imposing requirements . . . that are duplicative of requirements applicable to . . . nonbank financial companies under other provisions of law." And in the case of insurance

[25] Woodall Dissent at 4-5.

companies particularly, FSOC must take account of the McCarran-Ferguson Act of 1945,[26] which was enacted "to assure that the activities of insurance companies in dealing with their policyholders would remain subject to state regulation,"[27] to prevent federal intrusion, and to "restore to the States broad authority to tax and regulate the insurance industry."[28]

Together, these provisions establish that FSOC cannot designate companies engaged in traditional insurance activities without a rigorous assessment of the regulatory oversight to which the companies already are subject, and without appraising the degree to which designation and supervision by the Board of Governors of the Federal Reserve are necessary to avoid systemic financial distress. FSOC's designations to date do not reflect this analysis. In fact, they display only the most cursory acknowledgment that state regulation exists, rather than an affirmative evaluation of any areas where state regulation purportedly falls short and necessitates federal oversight. FSOC has even treated important state regulatory protections as *weaknesses*, rather than strengths, without any evidentiary basis. For example, insurers' ability to defer policy surrenders (typically for up to six months) is a crucial protection under state law, which among other things helps avert a "run" on an insurance company's assets. The informed judgment of state regulators—based on decades of experience—that deferral has a stabilizing effect should have been given great weight by FSOC in the Prudential decision. Instead, as discussed above, FSOC's Prudential decision used baseless speculation to hypothesize that deferral by an insurer that is publicly experiencing financial difficulty might help cause, rather than prevent, systemic

[26] 15 U.S.C. § 1011.

[27] *SEC v. Nat'l Sec., Inc.*, 393 U.S. 453, 459 (1969).

[28] *U.S. Dep't of Treasury v. Fabe*, 508 U.S. 491, 508 (1993).

distress.[29] That was arbitrary and capricious, and flatly inconsistent with FSOC's statutory mandate.

FSOC's failure to devote meaningful consideration to the existence and efficacy of existing regulatory protections has been a significant shortcoming in its designation decisions to date. It is important that, going forward, this be rectified.

4. FSOC Must Give Careful Consideration To The Consequences Of SIFI Designation

In order to satisfy its statutory obligations under the Dodd-Frank Act and the APA, FSOC must consider the *consequences* of designation, including the effects of designation on the company, its shareholders, and the public, and whether designating a company and subjecting it to Board supervision and enhanced prudential standards will further Dodd-Frank's purpose of mitigating potential threats to the financial stability of the United States.

This obligation to consider the consequences of regulatory action should be self-evident. Consequences are the *reason* for government action; unless the government determines that its action will make things better, it should stay its hand. On a more prosaic level, the failure to adequately consider the effects of regulatory action—and in light of those effects, whether a different regulatory approach would be preferable—is among the grounds on which federal agency actions are most commonly struck down by courts.[30]

In making SIFI designations, one of the most important consequences for FSOC to consider is the effect of heightened capital standards on the designated entity. The application of capital standards is among the principal results of SIFI designation and oversight by the Federal Reserve Board. Yet, it is widely recognized that capital standards designed for banks can be

[29] *See* Prudential Designation at 2.

[30] *See, e.g., Business Roundtable v. SEC*, 647 F.3d 1144, 1150-52 (D.C. Cir. 2011); *Timpinaro v. SEC*, 2 F.3d 453, 457-60 (D.C. Cir. 1993).

extremely ill-suited to entities that have very different liabilities than banks, and that perform entirely different functions in our economy. For example, in a recent speech in Chicago, Fed Governor Daniel Tarullo remarked on the difference between traditional insurance and banking, observing that "[t]here's more stability" on the liability side of the balance sheet for insurers, which "calls for a different concept of capital regulation for those parts of those firms."[31] Requiring insurers to adhere to capital standards designed for banks can force insurers to carry far more capital than necessary, potentially greatly increasing their costs and diminishing investment returns, with adverse effects for the designated insurer, its customers and investors, and even insurance markets as a whole. Bank-based capital standards may also give market participants a grossly distorted perception of an insurer's financial condition and viability.

These are serious issues. And they cannot be ignored by FSOC in the designation process. The purpose of designation is to fortify important financial institutions in order to reduce the likelihood of a problem at the designated entity that will adversely affect others. If instead SIFI designation will trigger requirements that are likely to *weaken* the company, then designation simply should not occur. FSOC would be gravely mistaken to proceed with SIFI designations in the belief that it may engage in reasoned decisionmaking while ignoring the consequences of its actions.

Yet in at least two different respects that I will now address, that is what FSOC currently appears to be doing.

[31] Craig Torres and Kim Chipman, *Tarullo Calls for Amending Statutes to Fine-Tune Bank Rules*, Bloomberg (May 8, 2014), *available at* http://www.bloomberg.com/news/2014-05-08/tarullo-calls-for-amending-statutes-to-fine-tune-bank-rules.html; *see also* Governor Daniel K. Tarullo, *Rethinking the Aims of Prudential Regulation*, Speech at the Federal Reserve Bank of Chicago Bank Structure Conference (May 8, 2014), *available at* http://www.federalreserve.gov/newsevents/speech/tarullo20140508a.htm.

5. FSOC Must Take Account Of Capital Standards In Making Designation Decisions; Indeed, Designation Is Premature Until Capital Standards Are Determined For Nonbank SIFIs

For reasons just explained, the anticipated effect of Board-imposed capital standards on a company is an important consideration in determining whether to designate the company as systemically important. There is widespread recognition that for insurance companies, for example, the capital standards applied to banks are inappropriate; indeed, those standards could give a highly misleading impression of the company's financial condition and materially weaken its financial position. Bank-based capital standards can deviate in material respects from the "risk-based capital" standards that already apply to insurers under state law and which, like so many features of the insurance regulatory system, were adopted and refined over time to address the nature and risks of the business of insurance specifically.

To date, the Federal Reserve Board has not established the prudential standards that will apply to designated nonbank financial companies—although Fed officials, including Governor Tarullo in his recent speech, have said that to a significant extent Dodd-Frank *requires* the Board to apply the same standards to insurers and banks.[32] Until this quandary is resolved, FSOC is—at minimum—unable to make a reasoned judgment that SIFI designation will not have the adverse consequences associated with applying bank-based capital standards to nonbank institutions. And for that reason, designating nonbank SIFIs now puts the cart before the horse.

As a recent article in *American Banker* magazine observed:

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[32] *See supra* n.31; *see also* Letter from Ben S. Bernanke, Chairman, Board of Governors of the Federal Reserve System, to Senator Susan Collins, at 2 (Feb. 6, 2012) ("Bernanke Letter"). Respected commenters believe that this assessment is mistaken (*see* Letter from Sullivan & Cromwell LLP to MetLife, Inc., Re: Application of Section 171 of the Dodd-Frank Act to Nonbank Financial Companies Designated for Supervision by the Federal Reserve Board (May 20, 2013), *available at* http://www.federalreserve.gov/SECRS/2013/May/20130523/R-1438/R-1438_052313_111291_554506713029_1.pdf), and legislation is pending that would make this clear through an amendment to Dodd-Frank (*see* S. 2270, 113th Cong., Capital Standards Clarification Act of 2014 (Apr. 29, 2014)).

> No company should be designated a SIFI before the FSOC knows what "more stringent" prudential standards the Fed will apply to it. In order to make a defensible SIFI designation, the FSOC needs to analyze how the standards would mitigate risks to financial stability, weigh the necessity of those standards and determine whether the standards are in fact stricter than the rules to which the company is already subject. To date, such analysis has been absent from the FSOC's nonbank SIFI designations.[33]

Given that the Federal Reserve Board has not yet promulgated capital standards for nonbank SIFIs, it is impossible for FSOC to know whether the costs and compliance burdens of subjecting nonbank companies to bank-like regulation will supersede the intended public benefits. Likewise, FSOC is not in a position now to explain how any particular designation would curtail systemic risk and avoid harm to the designated company and the U.S. financial system, despite the need to provide such an explanation under both the Dodd-Frank Act and the APA.

It has appeared at times that some government officials may view the FSOC designation process on the one hand, and the establishment of capital standards on the other hand, as distinct and unrelated processes that should proceed on separate tracks without paying heed to one another. Under this view, one federal agency—the Fed—is responsible for capital standards, while a different agency—FSOC—is responsible for designation. That view of the government's responsibilities is wrong, and it is troubling. We have one federal government; it should act in a unitary, consistent way. Indeed, FSOC was created to increase coordination within the government, not to increase balkanization. In no circumstance should our government set an American company on a regulatory path that may be harmful to the company, in the belief that it is appropriate for the left hand to disregard what the right hand is doing.

[33] Melanie Fein, *Why Nonbank SIFI Designations Put the Cart Before the Horse*, American Banker (May 8, 2014), *available at* http://www.americanbanker.com/bankthink/why-nonbank-sifi-designations-put-the-cart-before-the-horse-1067341-1.html.

6. FSOC's Company-By-Company Approach Results In Disparate Treatment Of Competitors Without Reasoned Explanation

A second respect in which the current FSOC process pays insufficient attention to the consequences of regulatory action is in the Council's decision to designate companies one-by-one, with no attention to how designating one company will affect it vis-à-vis competitors who continue to operate under vastly different regulatory requirements.

Under the law, an agency must "treat similar cases in a similar manner unless it can provide a legitimate reason for failing to do so."[34] However, in keeping with its inattention to the consequences of designation, FSOC has adopted a seriatim process for designating companies with little explanation of how those companies are being targeted, or how designation can be expected to affect the companies' competitive prospects. If a small number of companies are subject to regulatory requirements that impose materially higher costs than those borne by most of their competitors, those designated companies are placed at a significant competitive disadvantage. But, as currently administered, the SIFI designation process results in precisely this kind of inequitable treatment, with the divergence between the bank-based capital standards applied by the Fed, and the risk-based capital standards applied to insurers under state law, being just one example. Even if FSOC intends to consider designated companies' competitors for designation at some point in the future, it has provided no rational explanation for a process that risks placing some companies at a competitive disadvantage relative to others for an indefinite period of time.

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[34] *Indep. Petroleum Ass'n of Am. v. Babbitt*, 92 F.3d 1248, 1258 (D.C. Cir. 1996); *see also, e.g.*, *Burlington N. & Santa Fe Ry. Co. v. Surface Transp. Bd.*, 403 F.3d 771, 776-77 (D.C. Cir. 2005) (agency acted arbitrarily and capriciously when it subjected shippers and carriers to different standards with regard to efforts to vacate a rate prescription because the agency did not provide an "adequate explanation to justify treating similarly situated parties differently").

Conclusion

FSOC is a new agency with important responsibilities. Its discharge of those responsibilities to date presents some reasons for concern, and leaves substantial room for improvement. The standards FSOC is applying must be clearer, and the procedural rights of companies under consideration more robust. And to satisfy standards established by Congress and the courts, FSOC must correct an imbalance in its decisionmaking which gives insufficient attention to empirical evidence and the consequences of government intervention, and which places a thumb on the scales for designating companies systemically important by giving great weight to unsubstantiated speculation about what would happen if a company is *not* designated systemically important, while ignoring what will happen if the company *is* deemed systemically important.

Thank you for the opportunity to testify today. I would be happy to answer any questions of the Members of the Committee.

Testimony of

Deron Smithy

Treasurer

Regions Bank

On Behalf of

The Regional Bank Coalition

Before the

United States House of Representatives

Committee on Financial Services

Hearing on

"Examining the Dangers of the FSOC's Designation Process and Its Impact on the U.S. Financial System"

May 20, 2014

Chairman Hensarling, Ranking Member Waters and members of the Financial Services Committee. My name is Deron Smithy; I am the Treasurer of Regions Bank, based in Birmingham, Alabama. I appreciate the opportunity to speak to the Committee about the systemic risk designation, its impact on regional banks and the ways in which it can be improved. Regions Bank is a member of the Regional Bank Coalition, a group of eighteen traditional lending institutions that play a critical role in the Main Street economy. Regional banks are larger than $50 billion in assets but have basic, straightforward business models that do not present a threat to the stability of the U.S. financial system.

Overview

The Dodd-Frank Act (DFA) adopted a blunt approach for its definition of systemically risky bank holding companies, using a $50 billion asset threshold even though there are significant business model differences among the bank holding companies above that threshold limit—and for many regional banks, almost no differences in business model with those that are below the threshold. Nonbank financial firms are afforded a process—however opaque and problematic to some industry participants and observers—to determine whether they should be designated as systemic. Our view as regional banks, primarily engaged in traditional lending that benefits communities in all 50 states, is that bank holding companies, just like nonbank financial firms, deserve a hearing before the Financial Stability Oversight Council (FSOC) to determine whether or not we pose a systemic risk to the financial system. We believe that there is an effective, bipartisan legislative proposal (H.R. 4060) that would provide regulators—and the FSOC—with the appropriate flexibility to the Title I approach.

Creating a dynamic, business activity-based approach not only would establish a fairer method for evaluating banks in comparison to nonbanks, but it would strengthen regulators' ability to appropriately tailor rules to match the differences among banking organizations. This is not a new idea. The House of Representatives considered an activity-based approach in the early stages of its Dodd-Frank discussions. Furthermore, there already have been several proxies for the approach proposed in H.R. 4060, a bipartisan bill introduced in February 2014. The bill would have the regulators review five factors—including size, complexity, interconnectedness, international activity and substitutability—before making a systemic designation. Regulators have used these factors in other contexts to determine how firms might impact the stability of the financial system.

The Federal Reserve, working both by itself and with other U.S. and international banking regulators, has drafted numerous standards and proposals that distinguish among banks larger than $50 billion assets. They have some discretion within DFA to write rules that distinguish among banks; however, a more precise definition of systemic risk would allow for more effective prudential regulation and rulemaking. Congress could assist this approach—an approach supported by Federal Reserve Governor Daniel Tarullo in a May 8 speech—by enacting a more flexible definition of systemic risk and engaging the FSOC in that process for banks and nonbanks alike. Using an arbitrary asset threshold forces traditional regional banks that are engaged primarily in conventional lending activities to incur unnecessary expenses, puts them at a competitive disadvantage because they compete against banks of all sizes, and creates incentives to manage their asset bases to avoid exceeding the threshold instead of focusing on core business activities.

Regional banks operate in all 50 states, are critical sources of credit to small businesses and medium-sized firms, and have banking relationships with half of the U.S. households. [1] No regional bank has national deposit shares greater than 3% of the total; combined, regional bank assets are less than 2% of GDP. Regional banks are not systemic; we are not meaningfully interconnected with other firms and lack the complexity, significant participation in trading, derivatives and securities financing markets, global scope or the market dominance that could destabilize the financial system. Instead we provide credit to business owners and consumers. In fact, regional banks have far more in common in structure and operating model with community banks than globally active, complex firms.

The Goal: Tailored Regulation to Match Business Activities and Risk Profiles

Arbitrary asset thresholds distort markets and fail to provide regulators with the proper framework to tailor appropriate regulations for the different types of firms in the American banking system. Regulators recognize that regional banks should be treated differently in the DFA architecture than complex, interconnected banks. The regulators understand the limitations of an asset-only method of determining systemic risk, recognizing its fundamental imprecision, and, in fact, they rely on activity-based approaches in making key determinations about financial stability and systemic concerns. The Federal Reserve and international regulators adopted a multi-factor method to decide which complex, interconnected firms should be deemed to be systemically important on a global basis (the G-SIB designation). The Financial Stability Board tagged eight U.S. bank holding companies as G-SIBs; no U.S. regional banking organizations were designated. Furthermore, the Federal Reserve used activity-based standards—similar to those in H.R. 4060—in post-DFA, statutory evaluations of acquisitions by two regional banking organizations. The Federal Reserve approved the acquisitions, by PNC and Capital One,

[1] Regions Bank, SunTrust Bank, PNC Bank, Fifth Third Bank, Capital One Bank, Key Bank, Huntington Bank, CIT, Key Bank, BB&T Bank, TD Bank, RBS Citizens Bank, Comerica Bank, BBVA Compass, BMO Harris Bank, M&T Bank, Santander Bank and Zions Bank.

concluding that there would be no impact on U.S. financial stability. In approving PNC's purchase of RBC Bank, the Federal Reserve found that PNC engages "in a relatively traditional set of commercial banking activities, and the increased size of the combined organization would not increase the difficulty of resolving the organization's activities."[2]

The arbitrary $50 billion threshold is not a proxy for systemic risk. Systemic banks are "financial firms whose distress or failure has the potential to create broader financial instability sufficient to inflict meaningful damage on the real economy," as former Federal Reserve Chairman Bernanke said in a May 10, 2013 speech at the Federal Reserve Bank of Chicago.[3] This does not describe regional banking firms, as the Federal Reserve's own assessment of recent merger activity determined. More recently, Federal Reserve Governor Tarullo suggested in a May 8 speech that there should be a vigorous debate about how to create a more finely calibrated regulatory structure that recognizes business model differences, not just existing asset thresholds, in setting macro-prudential regulatory standards. In fact, for purposes of regulatory groupings, banks bigger than community banks (which he defined as larger than $10 billion in assets) but not G-SIBs represent a more coherent category than the banks divided by DFA's $50 billion threshold, Tarullo added.[4] Federal Reserve Chair Janet Yellen struck a similar point when she testified before the House Financial Services Committee in February. Relying on asset size only was not the best way to measure a bank's systemic importance, noting that the Fed is working "to tailor our regulations even with the $50 billion and above category, Yellen said."[5] The mismatch between the goals of regulators and the statutory definition of systemic risk resulted from political objectives when DFA was drafted, not economic and business model considerations. "By setting the threshold for these standards at firms with assets of at least $50 billion, well

[2] The Federal Reserve Board had to consider "the extent to which a proposed acquisition, merger or consolidation would result in greater or more concentrated risks to the stability of the United States banking or financial system." The Federal Reserve assessed numerous factors, including: asset size, competition and availability of alternative providers for services, interconnection, complexity and international activity. It further noted that even after the transaction, PNC would not engage in business activities or "participate in markets to a degree that in the event of financial distress...would pose material risk to other institutions." Federal Reserve System, Order Approving Acquisition of a State Member Bank (Dec. 23, 2011); http://www.federalreserve.gov/newsevents/press/orders/order20111223.pdf.
The Fed made a similar ruling when approving Capital One's purchase of ING Direct in 2012. FRB Order No. 2012-2, Federal Reserve System, Order Approving the Acquisition of a Savings Association of Nonbanking Subsidiaries (Feb. 14, 2012); http://www.federalreserve.gov/newsevents/press/orders/order20120214.pdf.

[3] Ben Bernanke, "Monitoring the Financial System," Presented at the 49th Annual Conference on Bank Structure and Competition sponsored by the Federal Reserve Bank of Chicago (May 10, 2013). Available at http://www.federalreserve.gov/newsevents/speech/bernanke20130510a.htm.

[4] Daniel Tarullo, "Rethinking the Aims of Prudential Regulation," Presented at the Federal Reserve Bank of Chicago Bank Structure Conference (May 8, 2014). Available at http://www.federalreserve.gov/newsevents/speech/tarullo20140508a.htm.

[5] Janet Yellen, House Financial Services Committee Hearing entitled "Monetary Policy and the State of the Economy," (Feb. 11, 2014). Available at https://www.bgov.com/news_item/rMUtHn1b101gyOxob1BLwA. Last month at a Brookings Institution event, former Fed chair Ben Bernanke responded to a question about too big to fail regulations by noting that "it's not just size...I think it has to do also with opacity, complexity, interconnectedness, and a variety of other things." Ben Bernanke, "Liquidity and the Role of the Lender of Last Resort," Presented at the Brookings Institution. (Apr. 30, 2014).

below the level that anyone would believe describes a 'too big to fail' firm, Congress has avoided the creation of a de facto list of too big to fail firms," Tarullo said in 2011.[6]

The Regional Bank Coalition believes that its time to move beyond the simple asset-only model to determine systemic risk because it does not match the reality of the U.S. banking system. A flexible approach informed some Dodd-Frank rule-makings and other regulatory actions; however, Federal Reserve policymakers are constrained, by statute, to expand many of its rules to include provisions for those firms above the existing $50 billion threshold that are not G-SIBS. [See Table 1 for threshold-based rules.] Ill-suited regulation stifles banks and offers no particular benefits to the customers we serve, taxpayers, or regulators. Rules designed for large, complex firms impose real, burdensome costs when applied to middle-market lenders. They weigh on our ability to operate competitively and could force us to curtail our primary activity, which for Regions Bank and other regional banking organizations is serving retail customers and making consumer and commercial loans to small businesses and midsize firms. Overly expansive regulation forces management—as well as the boards of directors—to focus too intently on these issues, distracting them from efforts to build businesses and execute strategic initiatives. Indeed, given regional banks' simpler operations and organizational structures, it is significantly easier for our management, directors, and regulators to understand the risks that we face and the processes we use to manage and control those risks. Finally, the costs have competitive implications. Regional banks compete in most markets against community banks (assets less than $10 billion) that are carved out of most regulation and Dodd-Frank costs. It "is important to emphasize that the majority of the provisions of the Dodd-Frank Act do not apply to community banks at all," former Fed Chairman Bernanke said in a 2012 interview.[7]

TABLE 1: SIGNIFICANT REGULATIONS WITH ASSET THRESHOLD TESTS

Topic	Threshold	DFA	Status
Annual capital plans (CCAR)	$50b	Non-DFA	Final/implemented
Supervisory stress tests	$50b	Sec. 165	Final/implemented
Capital surcharges	$50b	Sec. 165	TBD
Enhanced capital disclosures	$50b	Basel III	Final/2015 implementation
Liquidity risk management standards	$50b	Sec. 165	Final/2015 compliance
Liquidity Coverage Ratio	$50b	Basel III	Proposed
Single counterparty concentration limits	$50b	Sec. 165	Proposed
Risk management/Risk Committee requirements	$50b	Sec. 165	Final/2015 compliance

[6] Daniel Tarullo, "Regulating Systemically Important Financial Firms," at the Peter G. Peterson Institute (June 3, 2011); http://www.federalreserve.gov/newsevents/speech/tarullo20110603a.htm.
[7] Ben Bernanke, "Community Banking," Presented at the Independent Community Bankers of America National Convention and Techworld (3.14.12). http://www.federalreserve.gov/newsevents/speech/bernanke20120314a.htm.

Leverage (debt-to-equity) limits	$50b	Sec. 165	Final
Contingent capital rules	$50b	Sec. 165	TBD
OCC heightened expectations	$50b	Non-DFA	Proposed
Short term debt limits	$50b	Sec. 165	TBD
Enhanced public disclosures	$50b	Sec. 165	TBD
Credit exposure reports	$50b	Sec. 165	TBD
Resolution planning/"living wills"	$50b	Sec. 165/Title II	Final/2013 end to staged implementation
Federal Reserve enhanced reporting (FRY-14 and FRY-15 and FRY-2025b)	$50b	Non-DFA	Various stages: final and proposed rules
OFR/FSOC Assessments	$50b	Sec. 155	Final/implemented
Federal Reserve Assessment	$50b	Sec. 318	Final/implement
Durbin Amendment	>$10b*	Sec. 1075	Final/implemented
CFPB supervision/primary enforcement	>$10b*	Sec. 1025	Final/implemented
FDIC large bank pricing	>$10b*	Non-DFA	Final/implemented
FDIC insurance fund target	>$10b*	Sec. 334	TBD

*banks with assets <$10b were carved out of these requirements

Regulators have made some distinction in rule-makings, but not enough. Examples of the tiered approach include the filing deadlines for banks' DFA-required Title II resolution plans, primarily based on non-bank assets, and Volcker compliance standards.[8] Consistent with this view of divergent risk profiles, regulators finalized a leverage rule that only applies to BHCs with more than $700 billion in assets or more than $10 trillion in assets under management. Also, the Federal Reserve recently created a Large Institution Supervision Coordinating Committee (LISCC) that seeks to incorporate "systemic risk considerations into the supervision program." The LISCC aims to bring an interdisciplinary "approach to the supervision of ... large, systemically important financial institutions." The LISCC does not monitor any regional banking

[8] Under the Federal Reserve and FDIC's joint regulation implementing the DFA's resolution planning requirements, covered companies with more than $250 billion in total nonbank assets were required to submit their initial resolution plans before other covered firms and generally have been subject to more stringent regulation. The agencies explained in their preamble to the resolution plan rules that this "group comprises the largest, most complex" BHCs. 76 Fed. Reg. 67323, 67330 (2011). Tarullo, in his speeches and testimony, distinguishes between the "largest, most systemically important U.S. banking organizations" (for instance, the G-SIBs) and other banks that merely surpass $50 billion in assets. Two examples are his speech entitled "Toward Building a More Effective Resolution Regime: Progress and Challenges" at the Federal Reserve Bank of Richmond Conference (Oct. 18, 2013) . (Available at http://www.federalreserve.gov/newsevents/speech/tarullo20131018a.htm) and his testimony on Dodd-Frank Implementation to the Senate Banking, Housing and Urban Affairs Committee for their hearing entitled "Mitigating Systemic Risk Through Wall Street Reforms" (July 11, 2013). Testimony available at http://www.federalreserve.gov/newsevents/testimony/tarullo20130711a.htm.

organizations; however, it oversees several nonbank financial firms that recently went through the FSOC designation process.[9]

Effective, precise regulation will make the banking system safer; the current system saddles regional banks with excessive costs to implement and follow rules that do not reflect their business models. These costs—both direct and indirect—total hundreds of millions of dollars annually for individual regional banks; they impact productivity and can limit innovation—and these costs are growing more rapidly than other operating expenses for most banks. Regional lender M&T Bank spent $265 million on regulatory compliance in 2013, doubling the previous year's expense and a four-fold increase since 2007. The regulatory compliance spend accounted for 10% of the company's total operating expense, while it contributed to just 7% of those expenses in 2007.[10] At Regions Bank we have seen similar trends. Since DFA's passage, our risk management spending has more than doubled—an increase that is tens of millions of dollars annually. Regions Bank, for example, has more employees dedicated to regulatory compliance than we have commercial bankers building relationships with clients. And while in the past year Regions added 200 new associates in the Risk Management and Compliance areas, we also expect our bankers to participate in the supervisory, compliance and regulatory reporting requests from regulators. Our programs, undoubtedly, are more comprehensive and sophisticated than earlier; however, it is critical that they are commensurate with a bank's risk profile. In addition to direct costs such as new systemic regulatory fees, including the increased FDIC insurance fund assessment fees, regional banks also have additional expenses for new regulatory reporting, some of which, like Volcker and resolution plan submissions, offer little additional information to regulators about our business models. And not all of the systemic risk provisions have been finalized so these expenses can be expected to multiply.

Regional banks incur these new expenses as they face significant loss of revenue—especially in consumer businesses—totaling hundreds of millions of dollars annually due to new laws and regulations, including the Durbin Amendment. Bright-line asset thresholds designed to separate banks are not sound policy; they can create competitive imbalances that allow some banks to offer products at vastly different prices, thus harming harm certain banks and their customers. Lawmakers also have tried to use the threshold-designation in other contexts, such as tax policy, so it is important that the definitions are correct and are established through a more responsible designation process.

[9] In addition, a Senate proposal to address the risks of large, complex organizations, Terminating Bailouts for Taxpayer Fairness Act (S. 798), introduced by Senators Sherrod Brown (D-OH) and David Vitter (R-LA), proposes a $500 billion threshold, far above the DFA standard, for the highest capital levels.
[10] See 2013 and 2010 M&T Bank annual reports, http://mtb.mediaroom.com/2013AnnualReport and http://mtb.mediaroom.com/2010message

TABLE 2: SELECT REGULATORY COSTS, REGIONS BANK

Risk Management Spending	Expenses more than doubled from 2009-2013, an increase of tens of millions of dollars
Durbin Amendment (interchange revenue)	$170 million in foregone revenue annually
Foregone Revenue, from significant consumer regulation changes	$100 million annually
FDIC Assessment Fees (new DFA rules and the FDIC's changes to its calculation method	2013 assessment: $125 million 2008 assessment was $15 million
New Federal Reserve Fee	$2.75 million
Select Indirect Costs	
Dodd-Frank Act Implementation Team	A cross functional team of bankers, lawyers, risk managers and finance group associates that meets regularly to identify, track and monitor rules—both activity within the agencies but also the ways that the bank might have to alter its own business, internal control or compliance practices.
Rules	The team has identified 469 rules and agency actions to follow ➤ > 40 related to enhanced standards ($50b threshold) or holding company activity ➤ >100 related to Volcker rule or derivatives (although Regions does not engage in proprietary trading and does not have to register as a swaps dealer) ➤ >100 related to mortgage rules and CFPB activity

Regional banking organizations are not seeking to avoid rigorous scrutiny and proportional oversight. The Federal Reserve increased its supervision of large bank holding companies prior to the enactment of the DFA, through the creation of new capital planning and supervisory stress testing processes. The Federal Reserve's authority for these detailed, rigorous reviews and processes would remain, no matter the systemic designation. These exercises give the Federal Reserve unobstructed views into a bank's activities and balance sheet. Governor Tarullo highlighted the iterative process of the stress tests—and the value of the methods put in place before DFA—in his February 2014 testimony to the Senate Banking Committee. The "refinements, which have been informed by the extensive commentary and advice we get from the banks, technical experts, [and] policy analysts, continue to improve what I think is the single most important change in supervisory practice since the financial crisis," Tarullo said.[11] Moreover, regional banks remain subject to Basel III capital and liquidity requirements and numerous rules that set protective guardrails outside of Title I's enhanced prudential standards,

[11] Daniel Tarullo, hearing entitled "Oversight of Financial Stability and Data Security," Senate Committee on Banking, Housing, and Urban Affairs (Feb. 2, 2014).

such as the CFPB and new consumer regulations. Finally, the scrutiny includes constant business unit exams by federal and state regulators.

H.R. 4060

Regions Bank and regional banking organizations should be regulated according to our business models. H.R. 4060, a bipartisan bill introduced in February with Rep. Blaine Luetkemeyer (R-MO) as the lead, and five other House Financial Services Committee members as original co-sponsors,[12] strikes the $50 billion automatic threshold for systemic designation and calls for the FSOC to use the following five standards: size, interconnectedness, substitutability, international activity and complexity. In addition, this process would be similar to earlier drafts of the Dodd-Frank Act considered in the House of Representatives prior to final passage. The Regional Bank Coalition believes that the Luetkemeyer bill would improve the designation process because it uses an iterative approach and identifies the factors that create actual systemic risk rather than using a blunt instrument like asset size. The bill, if passed into law, would allow the regulators to focus their efforts where true risk to the system exists.

Regional Banking Model

The Regions business model, outlined in more detail below, is similar to peer regional banks. Regional banks are firms with assets of greater than $50 billion, but they fundamentally operate as traditional lending, community-focused, domestic commercial banks. Regional banks pose no systemic risk. They are important members of the local communities they serve, integral to the Main Street economy and to the financial lives of consumers and small and mid-size businesses. Regional banks are a meaningful part of the banking community in all 50 states. However, as individual banks, our size is modest in relation to the banking sector and overall economy. For example, no regional bank has national deposit shares equal to 3% of the total and most have a market share of less than 1%. In aggregate our assets are less than 2% of U.S. GDP, a total roughly equivalent to the single largest U.S.-based G-SIB.

Regional banks:

- Operate in all 50 states and serve local communities in more than 22,500 branches and offices
- Hold one-quarter of U.S. banking deposits
- Extend financial services to more than 60 million households, more than half of all U.S. households
- Originated more than $500 billion mortgage loans (about one of every seven mortgages)
- Provided more than $300 billion in other consumer lending
- Are important sources of credit to small and mid-sized businesses, including
    - Commercial and industrial loans: $400 billion

[12] Rep. Steve Stivers (R-OH), Rep. Spencer Bachus (R-AL), Rep. David Scott (D-GA), Rep. Patrick Murphy (D-FL) and Rep. Terri Sewell (D-AL).

- Small business loans (loans of <$1mm): $50 billion
- Small Business Administration loans: $2.3 billion
- Farm loans: $6 billion

The arbitrary $50 billion threshold creates a false barrier among traditional banks and it pulls some of those banks into the same regulatory architecture as more complex, interconnected financial firms. [13] The similarity in the business model of traditional banks can be measured by various activity-based metrics, including how we fund and our lending focus.

TABLE 3. BANKING METRICS, FIRMS WITH >$10 BILLION IN ASSETS

	Banks with assets >$10 billion but <$50 billion (50 banks)	Regional Banks
Loan-deposit ratio	85%	85%
Loan-asset ratio	65%	65%
Commercial & Industrial loans, as % of all loans	19%	24%
Funding: deposits as % of liabilities	86%	88%
Trading Assets	<1%	<1%

Source: SNL

Indeed, funding sources, including the use of core deposits versus short-term borrowings, underscore the different operating models between regional banking organizations and more complex firms. This issue is a top priority for regulators; the FSOC's *2014 Annual Report* lists "short-term wholesale funding markets" as the first on its list emerging threats and topics for reform. Regional banks rely on core deposits, not short-term borrowings, to fund their operations. Core deposits are equal to 72% of assets compared to just 29% for the U.S. G-SIBs. Other metrics further differentiate lending-focused regional banks and complex, interconnected firms. Two-thirds of regional bank assets are loans compared to less than half of the assets of the four largest bank holding companies. The distinctions can be measured in the structure and scope of operations, including non-bank activities (such as trading and market-making) and international operations, as well as complexity of the firms and their interconnections. Consider the differences between regional banks and the eight U.S. bank holding companies that already have been tabbed as globally system (G-SIBs) by international regulators:

- Regional banks are more likely to engage in traditional lending. Regional banks have a loan-to-deposit ratio of 88% and net loans and leases represent 65% of assets compared to 61% and 25% for the G-SIBs.

[13] Daniel Tarullo, "Rethinking the Aims of Prudential Regulation," Presented at the Federal Reserve Bank of Chicago Bank Structure Conference (May 8, 2014). Available at http://www.federalreserve.gov/newsevents/speech/tarullo20140508a.htm .

- Regional banks are less complex. Their broker-dealer assets account for less than 1% of total firm assets compared to close to 20% for the G-SIBs. Looking at it another way, the six largest U.S. banks have three times as many subsidiaries as the next 44 banks.
- Finally, regional banks are U.S. institutions. Less than 1% of their deposits and loans are outside the U.S., while the corresponding numbers are 28% and 18% for the G-SIBs.[14]

Regions Bank

Regions Bank is a community-focused, diversified lender that operates in sixteen states and offers a range of consumer and business lending products and services. We have a simple yet effective model that focuses on relationship banking through high quality customer service coupled with industry expertise. Regions provides banking services to hundreds of thousands of businesses and to millions of households that benefit people that live in all types of communities and that are at all stages of the borrowing and saving continuum. Even in a time of slow economic growth, Regions is moving forward and making progress. Simply put, Regions is growing loans and adding customers. And we are investing in our operations and technology infrastructure to offer better services and meet changing regulations.

TABLE 4. REGIONS BANK KEY FACTS

Loans/rank	\$76 billion/13th
Commercial Loans	\$46 billion
Consumer Loans	\$29 billion
Branches/ATMs	1,700/2,100
Commercial Customers	500,000
Small Business Customers	450,000
Households	4.4 million
Deposits/rank	\$93 billion/14th
Employees	23,687

Regions' commercial focus is on small and medium-sized businesses that are dependent on traditional bank credit for financing. Our balance sheet includes $46 billion in commercial loans; we serve 500,000 commercial customers overall, including 450,000 small business owners. These clients live and operate businesses both in rural communities and major metropolitan areas. In serving our corporate, middle market and small business customers, we compete against all types of banks, from the largest national banks to smaller community banks. Several years ago we might have competed against one or two banks when renewing loans or seeking to make a new loan, our bankers now regularly face four to five competitors. This is especially true in the small business and middle market spaces, where we compete fiercely against regional and

[14] See for instance, the January 31, 2014 comment letter from several regional banks to the regulators, including to the Federal Reserve on the *Notice of Proposed Rulemaking for the Liquidity Coverage Ratio: Liquidity Risk Measurement, Standards and Monitoring.*

community lenders. Fewer banks vie for corporate accounts because they need more sophisticated services and have larger capital needs.

The consumer bank serves more than 4 million households and we hold $29 billion in consumer loans on our balance sheet. We strive to meet the financial needs of all types of consumers in our markets—from those who need short-term credit and check-cashing services to higher income customers relying on our wealth management services. In fact, we have significantly grown our product suite in the past several years and innovation—both in how we interact with customers and the services we offer—is as critical to our business success as is strong customer service and the development of long-term relationships with our clients. Our mortgage business reflects our conservative banking principles. We only originate mortgages through our own bankers and we exited the subprime business ahead of the credit crisis. As early as the summer of 2007 we developed a customer assistance program (building on our responses to Hurricane Katrina) to help our customers as the recession began. As a result of our origination and underwriting guidelines, as well as our willingness to reach out to customers in need, we have mortgage delinquency and foreclosure rates below industry averages.

Regions operates in diverse markets: from rural America to major metropolitan areas. In particular, we serve Americans in midsize and smaller metro markets, and we operate in places where our most significant competition comes from community banks. We are the community bank in those areas. While Regions is a top ten bank (measured by deposits) in two-thirds of the largest 25 MSAs in our footprint, we also are in nearly all (96%) of the MSAs with less than 100,000 residents and we have a strong presence in rural towns and counties in our footprint states. To highlight this diverse footprint and our commitment to provide banking services to many types of communities:

- A majority of our deposits (51%) come from communities that have less than 1mm people; additionally, 5% of our deposits come from rural areas; in contrast, just 11% of the deposits of one of our money-center bank competitor's come from metro areas with populations less than 1mm people. Also, they collect just .3% of their deposits from rural communities.
- 60% of our branches are in communities or metropolitan areas of less than one million
    - In comparison, just under 30% of the branches of a big-bank competitor's are in communities of less than 1mm people.
    - Nearly 10% of our branches are in rural counties, while 1% of the money center competitor's branches are in rural counties.

In addition, Regions has loaned out about $1 billion in small business loans to customers in our non-metropolitan communities and is a significant lender to farmers and firms that provide agricultural services. Our $1.2 billion agriculture portfolio makes Regions a top-ten agricultural lender among traditional commercial banks.

We compete against banks of all sizes throughout our markets. For example:

- In Birmingham, the market where Regions has the most deposits (population: 1.1 million), the bulk of our competition comes from regional and mid-size banks (assets greater than $10 billion), though one money center and many community banks also have market presences.[15]
- In Tampa (population: 3 million), our 3rd largest deposit market, regional banks and money center banks each have about 40% market share.
- In many of our core markets in smaller metropolitan areas, such as Knoxville and Chattanooga, Tennessee, our competitors are almost exclusively smaller regional banks and community banks.

Conclusion

The current statutory designation of all banks with more than $50 billion in assets as systemic is imprecise, results in non-systemic banks being lumped together with truly complex, financially interconnected firms for regulatory purposes, and saddles regional banks with costs that are not necessary. Regional banks do not threaten the country's financial stability nor are they complex organizations—with thousands of subsidiaries and meaningful nonbank activities—that would be difficult to resolve in a crisis. The current standard does not best serve banks, taxpayers, small business owners and other borrowers in our communities, or the regulators. The regulators have requested the need for a more tailored, risk-focused framework for identifying firms that may, in fact, present true systemic risk so that they can apply enhanced regulatory standards to address those risks. A multi-factor, activity-based test along with a fair and transparent designation process, such as proposed in H.R. 4060, would accomplish this goal.

[15] Market share is based on deposits; all data is from SNL.

American Enterprise Institute
for Public Policy Research

Statement before the House Committee on Financial Services
On "Examining the Dangers of the FSOC's Designation Process and its Impact on the U.S. Financial System"

Testimony on the Designation of Systemically Important Financial Institutions by the Financial Stability Oversight Council and the Financial Stability Board

Peter J. Wallison

Arthur F. Burns Fellow in Financial Policy Studies

American Enterprise Institute

May 20, 2014

The views expressed in this testimony are those of the author alone and do not necessarily represent those of the American Enterprise Institute.

The Designation of Systemically Important Financial Institutions by the Financial Stability Oversight Council and the Financial Stability Board:

Peter J. Wallison
American Enterprise Institute

Chairman Hensarling, Ranking Member Waters, and members of the committee:

Thank you for the opportunity to testify this morning on the designation of systemically important financial institutions (SIFIs) by the Financial Stability Oversight Council (FSOC). I believe this issue deserves serious attention by Congress. I am Peter Wallison, Arthur F. Burns Fellow in Financial Policy Studies at the American Enterprise Institute. The views expressed in this testimony are my own and not necessarily those of the American Enterprise Institute.

Financial services is one of the most important and successful industries in the United States. It includes banks, of course, as well as insurers, asset managers, securities broker-dealers, finance companies, private equity firms, and hedge funds, among others. The services of these companies enable main-street Americans to buy and sell assets, and to save for the future to purchase a home, send children to college or retire comfortably. As important, financial services channel these savings into financing for business, which in turn creates jobs and—through growth in productivity—improves the standard of living for all of us.

Although some observers of the financial markets favor more regulation than others, it is not in dispute that financial regulation can have a significant effect on the performance of financial institutions, and thus on economic growth. For this reason, Congress should have a major role in formulating the policies that underlie the regulatory decisions that affect the US financial industry. However, in the case of banking regulation, Congress has generally not intervened in the development of the bank capital regulations. Basel I, II and III were developed by bank regulators , approved by an international agreement among bank regulators, and subsequently applied to the US banking industry. Later in this testimony, I discuss reasons why congressional abstention from this process was not a good idea.

The Dodd-Frank Act, the FSOC, and growth in the scope of regulation

In 2010, in the wake of the financial crisis, Congress adopted the Dodd-Frank Act, which created a special body known as the Financial Stability Oversight Council (FSOC). The FSOC is composed of the heads of all the federal financial regulators—the Federal Reserve, FDIC, SEC, CFPB, etc.—and a person who is appointed by the President and confirmed by the Senate as an expert in insurance, an industry that is not regulated by the federal government. The secretary of the Treasury is the chairman of the FSOC and runs the meetings. The secretary also has an effective veto over the FSOC's most important decisions, since his affirmative vote is necessary for approval. Because the act specifies that the members are the *heads* of the regulatory agencies—not the agencies themselves—virtually all the members are appointees of the administration in power. They are not required to represent their agencies' views and they don't; they seem generally to follow the directions of the Treasury secretary. This in itself is highly unusual for a regulatory agency. In creating other regulatory agencies, particularly those that engage in financial regulation, Congress has generally set up bipartisan commissions, in order to ensure that different views are brought to bear on contentious regulatory matters where

significant parts of the economy could be harmed. The FSOC is almost unique in the sense that it is made up principally of appointees of the administration in power, and is headed by the secretary of the Treasury, a political appointee. This means that important and controversial decisions of the FSOC can be made on the basis of political or ideological factors rather than fully debated as regulatory or supervisory matters. There is strong evidence that most of the members of the FSOC know little about the decisions they are asked to make, and simply follow the directions of the secretary of the Treasury as the senior administration official at the table.

Dodd-Frank enjoins the FSOC to "identify risks to the financial stability of the United States that could arise from the material financial distress or failure, or ongoing activities, of large interconnected bank holding companies or nonbank financial companies." (Sec 112). The act designates all banks or bank holding companies with more than $50 billion in assets as systemically important financial institutions (SIFIs) and subjects them to special stringent regulation by the Federal Reserve Board (Fed), but it leaves to the FSOC the task of designating nonbank financial institutions as SIFIs. To implement this idea, Section 113 authorizes the FSOC to designate a nonbank financial firm as a SIFI if "the Council determines that material financial distress at the US nonbank financial company...could pose a threat to the financial stability of the United States." Firms so designated are then turned over to the Fed for prudential regulation which Section 115 requires to be more "stringent" than the regulation to which firms of the same type are ordinarily subject. Section 115 and other provisions of the act suggest that this regulation be bank-like—that is, it should involve regulation of their capital and supervision of their risk-taking activities.

The conventional narrative about the financial crisis has created major new opportunities for regulators.

Bank-like regulation of nonbank firms is a sharp change in substantive US regulatory policies from those that prevailed in the past. The 2008 financial crisis was a disaster for the American people, but it was a huge gift for financial regulators in the US and abroad. After all major financial downturns, those who support government involvement in the economy claim that it wouldn't have occurred if financial regulators had more power. Congress usually gives in to this argument, despite the evidence. The collapse of the S&Ls in the late 1980s brought forth the Financial Institutions Reform, Recovery and Enforcement Act of 1989 (FIRREA) and the FDIC improvement Act of 1991 (FDICIA). The Enron scandal produced the Sarbanes-Oxley Act. All these new laws promised to prevent the recurrence of the prior events such as banking or financial crises. As we can see from the 2008 financial crisis, they did not perform as advertised. Despite statements to the contrary by people who should know better, there has been no deregulation of the financial system in the last 30 years, while many other areas of the economy—securities trading, communications, trucking and air travel—have been deregulated with huge benefits for the American people. The plain fact about financial regulation is that existing regulation creates repeating crises, which in turn bring forth additional regulation, culminating in the recent financial crisis.

The 2008 financial crisis had many elements of earlier crises, except in two respects: it was much larger than any previous crisis and it involved the whole financial system and not just depository institutions. The narrative that grew out of the crisis was, once again, that it could

have been prevented if the regulators had more power.[1] But there was a difference; before the crisis, the only theory for federal prudential regulation of financial institutions supported the regulation of banks; since banks were backed by the government, prudential regulation—requiring capital and controlling risk-taking—was necessary to prevent moral hazard and to protect the taxpayers. But after the crisis, which involved many large financial institutions in addition to banks, the conventional Washington narrative became something far more expansive. In that narrative, the failure of any large financial institution could be a danger to the entire financial system. This spawned a wholly new and expansive theory for regulation—that the risk-taking and capital position of *any* financial institution should be subject to prudential bank-like regulation if there is even a minimal case that its failure could cause a financial crisis. That's why the Dodd-Frank Act adopted the idea that any firm should be subject to this regime if its "financial distress" could cause "instability in the US financial system." However, since it is impossible to know in advance whether a particular institution's "distress" would cause "instability in the US financial system" (whatever *that* is), the FSOC's authority is in effect a blank check to consign to Fed regulation any large financial firm that the government wants to regulate.

I need not tell many members of this committee that the narrative that brought about this major shift in regulatory policy was false. The financial crisis was not caused by insufficient regulation of the financial system; it was caused by government housing policies that built an enormous bubble between 1997 and 2007 and suffused the financial system with subprime and other low quality mortgages. These defaulted in unprecedented numbers in 2007 and 2008 when the bubble deflated, severely weakening banks and other large financial institutions. Banks in particular were hard hit because the government-mandated capital requirements had encouraged them to hold mortgage backed securities that lost substantial value when the mortgage defaults began. When Lehman Brothers was allowed to fail in September 2008, a huge investor panic ensued that we know as the financial crisis.

The practical effect of the huge shift in regulatory policy, based on this misreading of the cause of the crisis, was a large increase in the potential reach of bank-like prudential regulation and a large corresponding increase in regulatory power. Now, *all* large financial institutions in the US—not just banks—can be made subject to bank-like prudential regulation unlike anything they have faced before. Given the unprecedented character of this power, it seems reasonable that Congress should have a say, at the very least, about how this change in the scope of regulation is implemented, especially because substantial increases the extent and cost of regulation can have a substantial effect on economic growth and the well-being of all Americans.

Much of the rest of my testimony will discuss why congressional intervention is necessary as a matter of broad policy, but I'd like to mention one fact at this point that I think will be particularly salient with Congress. Recently, the FSOC has taken steps that indicate it is likely to designate large asset managers as SIFIs. When this became known, Barney Frank, the chief House sponsor of the Dodd-Frank Act and the authority of the FSOC, said that he had

[1] See, e.g., the majority Report of the Financial Crisis Inquiry Commission, from which I dissented. http://www.aei.org/files/2011/01/26/Wallisondissent.pdf

never intended that asset managers should be considered SIFIs.[2] Nevertheless, the breadth of the language in the congressional authority given to the FSOC does not prevent the FSOC from going this far. If Congress didn't intend this, it should step in to make its intentions clearer to the FSOC.

The scope of the FSOC's authority

The first thing to be said about the language of Section 113 is that it is an extraordinary grant of authority, and essentially permits the FSOC to determine the scope of its own jurisdiction. This can be done by reaching out to designate any financial institution operating in the US that the FSOC believes could cause instability in the US financial system. There is no outer boundary, such as size or type of company, in this grant of authority. Although the courts often frown on this when it is called to their attention, it is unlikely that this particular grant of authority will ever be tested; regulated firms, fearing retaliation, are very reluctant to challenge the legal authority of their regulators. Indeed, after Prudential Financial was designated as a SIFI, the firm initially suggested that it would challenge the FSOC's decision, but after going through a pro forma administrative appeal process decided not to engage.

The Dodd-Frank language that authorizes the FSOC to designate SIFIs is seriously flawed. Key terms the FSOC must apply in order to take jurisdiction over any particular firm—"financial distress" and "market instability"—have no clear meaning, and because both involve predictions about the future, they amount to an enormous grant of discretionary power. Where judicial intervention is unlikely, as in this case, wide discretionary power can result in arbitrary, capricious and politically-based administrative decisions. An agency can rectify this problem by developing and applying standards that limit its own discretion, providing a roadmap for compliance by affected companies, and allowing the basis of its decisions to later be judged by Congress and the public. However, the FSOC has not developed any such standards. Quite the opposite. In its recent decision to designate the insurance firm Prudential Financial as a SIFI, the FSOC studiously avoided any standards that might limit its discretion in the future. As a result, other insurers can have no idea what they should do or not do to avoid a SIFI designation, and there is no way for Congress or anyone else to determine whether the FSOC is acting objectively and carefully with its extraordinary statutory mandate. For example, in summarizing its Prudential decision, the FSOC stated:

> Prudential is a *significant* participant in financial markets and the U.S. economy and is *significantly* interconnected to insurance companies and other financial firms through its products and capital markets activities. Because of Prudential's interconnectedness, size, certain characteristics of its liabilities and products,...material financial distress at Prudential could lead to an impairment of financial intermediation or of market functioning that would be sufficiently severe to inflict *significant* damage on the broader economy.[3] [emphasis supplied]

[2] Joe Morris, "Fidelity not a 'systemic risk' in Barney Frank's book," *Financial Times*, December 8, 2013.

[3] Financial Stability Oversight Council, "Basis for the Financial Stability Oversight Council's Final Determination Regarding Prudential Financial, Inc.," September 19, 2013, p2

Although this was a summary paragraph, it was never followed by any numerical or otherwise intelligible analysis of Prudential's effect on the market if it should encounter financial distress. In its 12 page statement, The FSOC used the term "significant" 47 times. The most useful numerical data in the whole statement were the page numbers. Thus, the first concern that Congress should have about the FSOC is that it is failing to circumscribe its discretionary authority in any way that will give financial institutions a way to change their activities in order to avoid a SIFI designation, or a way for Congress to determine whether the FSOC is carrying out its extraordinary mandate as Congress had intended. Or, indeed, whether the agency is acting arbitrarily in designating firms without a rational basis for doing so. If the agency is unable to meet these basic tests, its authority should be taken away.

Dodd-Frank suggests many factors that the FSOC should consider in addition to size—such factors as interconnectedness, leverage, and maturity mismatch—but the FSOC has refused to provide any indication of how these criteria will be weighted. For example, all financial firms are interconnected with others in some way, but what degree of interconnection will be considered a reason to designate a firm as a SIFI? The failure to specify how it will define and weigh these issues preserves maximum discretion for the FSOC but provides no useful information to firms that wish to avoid designation. The FSOC's designations of AIG and GE Capital, which preceded the designation of Prudential, were similarly opaque.

But there is another point that makes the FSOC's power particularly troubling. As noted earlier, the pattern established in bank regulation—and implicitly accepted by Congress—is that agreements among international regulators can become the rule in the US without the express approval of Congress. This pattern was established with the capital accords of the Basel Committee on Bank Supervision in the 1980s. We are all familiar with the substance of these capital rules, in which bank regulators from the developed countries got together and decreed that while 8 percent risk-based capital was the suitable capital charge for the risk of a corporate loan, only 4% was necessary for a mortgage and 1.6% for high quality mortgage-backed securities. These internationally-agreed rules were made applicable to all US banks by the US bank regulators. Congress never voted on any of this, although Congress clearly acquiesced in these rules. There was no debate on whether these rules were good policy.

It turned out that the Basel capital rules were terrible policy. They encouraged banks worldwide to buy mortgage-backed securities that were rated triple-A, because the capital charge was so small. And when the mortgage-backed securities market collapsed in 2007 and 2008, the resulting losses led directly to a financial crisis because most banks had followed the incentives created by the Basel capital rules. In other words, international regulatory accords, which can be very popular with *regulators* because they eliminate regulatory competition (usually called "opportunities for regulatory arbitrage" by the regulators) can be very bad policy, and can become law in the US without any kind of serious debate in Congress. This experience should give Congress pause before it acquiesces in a similar process again.

This is especially true in SIFI designations, where the FSOC has wide discretionary authority from Congress to identify specific institutions for special and stringent treatment. It would be unprecedented and not within the likely contemplation of Congress if this judgment were to be made through an international agreement among regulators, without the thorough case-by-case decision-making that Congress seems to have expected the FSOC to provide when

it makes SIFI designations. Yet that seems to be exactly what is happening now through the work of an international body of central banks, financial regulators and government officials called the Financial Stability Board (FSB).

The authority of the Financial Stability Board

In November 2008, shortly after the financial crisis, the leaders of the G-20 countries met in Washington, DC. There, they authorized the FSB to effect "a fundamental reform of the financial system, to correct the fault lines that led to the global financial crisis and to rebuild the financial system as a safer, more resilient source of finance that better serves the real economy."[4] Both the Treasury and the Fed are members of the FSB, along with representatives of all the major developed countries and many other international government organizations.

The fact that the FSB was directed by the G-20 leaders to bring about a fundamental reform of the international financial system is important. To the regulators and finance ministers that are part of the FSB process, the G-20 leaders are their political masters. From their point of view, the FSB is carrying out the policies of their leaders. President Obama was of course part of the G-20 leader group that directed the FSB to take steps that would make the financial system safer, so the Treasury is simply implementing this direction, like any other decision of the president. The political direction from the top undoubtedly makes it easier for the FSB to achieve consensus on specific steps. It also means that the FSB is not going to stop of its own accord until it gets a counter direction or meets an obstacle of some kind.

Thus far, the FSB has designated 39 banks and 9 insurance firms (including the US insurers AIG, Prudential and MetLife) as global SIFIs. In making these designations, the FSB did not announce publicly either the standards that it used, if any, or the way the standards were applied to the banks or insurance firms that were designated as SIFIs. In the case of the insurance firms, the International Association of Insurance Supervisors (IAIS) had developed (at the request of the FSB) a methodology that purported to assign weights to various activities. For example, mere size was accorded a 5% weight, while interconnectedness was accorded 40% and non-insurance or bank-like activities were accorded 45%. Whether one agrees with these weightings or not, it sounds like there could have been a legitimate designation process using these standards. But it was not to be. It seems instead that the FSB made its designations without saying how it applied the IAIS methodology to any particular insurer. This is a pattern that, as outlined above, has been repeated at the FSOC. It is typically adopted by regulators when they do not want to limit their discretion in the future. It is also the hallmark of a "we know-it-when-we-see-it" approach to designation that can't be what Congress had in mind for the FSOC.

One important question about how the FSB made its designations is the role of the Treasury and the Fed in the FSB's decision process. At the very least, both agencies had to acquiesce in that decision; it is highly unlikely that the FSB would have designated three US insurers as global SIFIs if the Treasury and the Fed had objected. A legitimate basis for such an objection would have been that the process of designation in the US was not complete, so the Treasury and the Fed could not vote in favor of the FSB's designation. If they did not raise an

[4] Financial Stability Board, "Overview of Progress in Implementation of ther G20 Recommendations for Strengthening Financial Stability" *Report of the Financial Stability Board to G20 Leaders*, September 5, 2013, p3.

objection—in other words if they acquiesced—they had already prejudged the designation of Prudential before the decision was made by the FSOC. This should be unacceptable to Congress or any fair- minded person. In a hearing on May 8, 2014, Congressman Garrett tried but was unsuccessful in getting an answer from Treasury Secretary Lew that explained whether the Treasury had concurred or acquiesced in the FSB's Prudential designation. That is something that Congress must determine in order to decide whether the FSOC is carrying out a fair and honest inquiry when it designates financial firms as SIFIs.

Relationship between the FSB and the FSOC

It is likely that the FSB, which has no enforcement mechanism of its own, expects to follow the pattern of the Basel Committee on Banking Supervision when it makes its designations. In that case, an agreement among all the central banks and financial regulators that are participating in the decision will designate certain financial institutions to be SIFIs, and any special regulation associated with designation will be carried out by their home country regulators. If this process is followed, the FSOC will simply implement the FSB's decisions in the United States. Congress will hold hearings, but there will be no legislation, no debate and no vote. As noted above, it was a mistake for Congress not to raise questions about the Basel capital accords, and it would be another and more serious mistake for Congress to acquiesce in SIFI designations because they were made pursuant to an international agreement of regulators.

It is important for Congress to keep in mind that regulators are interested in broadening the breadth of their authority, and when they can reach an international agreement on regulations they enhance their authority because the regulated industries have fewer opportunities to avoid regulation by moving operations elsewhere. As noted earlier, regulators call this freedom of regulated firms to move elsewhere "regulatory arbitrage," but one advantage of regulatory competition (i.e., different rules in different places) is that it keeps regulation from stifling innovation and change. This is the lesson of the Basel capital accords, which drove many banks to invest in mortgage-backed securities and thus weakened them all at the same time when mortgages declined in value in 2007 and 2008, bringing on the financial crisis.

It may be that the Treasury and Fed, because of the G-20's direction, expect to follow the rulings of the FSB through the FSOC. There are several indications that this is what is happening. Thus far, it appears that the FSOC is simply implementing the earlier FSB policy and designation decisions. For example, the FSB has recommended that if money market mutual funds do not adopt a floating net asset value, they should be subject to capital requirements like banks.[5] The FSOC then pressured the Securities and Exchange Commission to adopt similar rules for money market funds. The FSB has indicated that all asset managers with assets of more than $100 billion may be subject to prudential regulation.[6] Then, the Office of Financial Research, another Treasury agency created by Dodd-Frank, produced two reports at the request of the FSOC to support the idea that large asset managers should be designated as SIFIs. The FSB has designated three US insurance firms as SIFIs—AIG, Prudential, and MetLife—and the

[5] Financial Stability Board, "Overview of Progress in the Implementation of the G20 Recommendations for Strengthening Financial Stability," September 5, 2013, 24.
[6] Financial Stability Board, "Assessment Methodologies for Identifying Non-Bank Non-Insurer Global Systemically Important Financial Institutions: Proposed High-Level Framework and Specific Methodologies," consultative document, January 8, 2014, www.financialstabilityboard.org/publications/r_140108.pdf.

FSOC has already designated AIG and Prudential as SIFIs and is currently investigating MetLife for a possible SIFI designation. These parallel decisions again suggest that unless Congress asserts its interests, the SIFI designation process will devolve into the implementation of policies and decisions of the FSB.

The likelihood that the FSB, the FSOC and the Fed will coordinate their activities is high. In a sense, it could not be otherwise; the Treasury and the Fed are members of the FSB, probably the most important members; if they participate in discussions that lead to an agreement, as they do, they have to implement that agreement in the US. Given the importance of the US market and US financial institutions, it is difficult to imagine that the FSB would make any SIFI designations without the concurrence of the Treasury and the Fed, and it is difficult to imagine that the FSB could designate a US financial firm as a SIFI while the FSOC does not. This would put the US firm in a position of operating at home and abroad under rules that are different from—and probably less stringent—than those imposed by the FSB. Similarly, if the FSOC were to designate a US firm as a SIFI while the FSB does not, the US firm would be at a competitive disadvantage in competing outside the US. Accordingly, it is reasonable to assume that the FSOC and the FSB are eventually going to come to identical conclusions for which firms are SIFIs and which are not.

This raises questions about the objectivity of the investigative and analytical work that the FSOC is supposed to do before declaring US firms to be SIFIs under the Dodd-Frank Act—a concern that is fully validated by the kind of analysis the FSOC did in the Prudential case. There, the FSOC produced what can only be called a perfunctory decision. All the bank regulators, who know nothing about insurance regulation, voted for designating Prudential as a SIFI, but Roy Woodall, the sole voting member of the FSOC who has insurance expertise and is the Independent Person appointed to the FSOC because of his insurance knowledge, had this to say in his dissent:

> In making its Final Determination, the Council has adopted the analysis contained in the Basis [the FSOC's statement of its reasoning and analysis]. Key aspects of said analysis are not supported by the record or actual experience; and, therefore, are not persuasive. The underlying analysis utilizes scenarios that are antithetical to a fundamental and seasoned understanding of the business of insurance, the insurance regulatory environment, and the state insurance company resolution and guaranty fund systems. As presented, therefore, the analysis makes it impossible for me to concur because the grounds for the Final Determination are simply not reasonable or defensible, and provide no basis for me to concur. [7]

Woodall played it straight, but the decision on Prudential seems to have been baked in the cake before it was made by the FSOC. The fact that the FSB, the preceding July, had already determined that Prudential was a SIFI—with the concurrence or at least the acquiescence of the Treasury and the Fed—made it inevitable that the FSOC would come to the same conclusion. It seems highly likely that the FSOC will make the same decision about MetLife, which has also

[7] Roy Woodall, "Views of the Council's Independent Member having Insurance Expertise," p1, http://www.treasury.gov/initiatives/fsoc/council-meetings/Documents/September%2019%202013%20Notational%20Vote.pdf

been designated as a SIFI by the FSB. Clearly, if the Basel Committee's procedures are followed in the FSB and acquiesced in by Congress, many large nonbank financial institutions in the US may become subject to prudential bank-like regulation for reasons other than the objective analysis that Dodd-Frank expected the FSOC to apply.

The FSB, the FSOC and Shadow Banking

The most problematic element of the SIFI designation process is the transparent effort of bank regulators to get control of what they call "shadow banking." Since the financial crisis in 2008, central bankers and bank regulators world-wide have repeatedly called for controls on "shadow banking." Federal Reserve officials, including former Chairman Ben Bernanke, have been among the most outspoken on this matter. At the 2011 Cannes summit, and again at its Los Cabos summit in 2012, the G-20 leaders called on the FSB strengthen the oversight and regulation of "shadow banking." It would be interesting to know what the G-20 leaders thought they were approving when they endorsed a regulatory program for something as technical as shadow banking, especially since in 2011 it had not been defined by anyone at that point, including the FSB.

The FSB finally defined shadow banking in 2012. Shadow banking, it said, is "credit intermediation involving entities and activities (fully or partially) outside the regular banking system."[8] Taken literally, this language is absurdly broad, since it covers all financial intermediation that is not subject to bank-like regulation, but in subsequent statements the FSB has not stepped back from the breadth this definition.

It would be easy to define shadow banking narrowly and get at least some buy-in from the financial community. The defining characteristic of banks is that they perform something called maturity transformation—that is, they turn their short-term deposits into long term assets by making loans. It's a risky business, and in the modern world is somewhat protected by deposit insurance, which reduces the tendency of depositors to withdraw their funds (often called a run) when they believe the bank's financial condition is weak.

During the financial crisis there were a number of institutions—Lehman Brothers and Bear Stearns being two—that failed or came close to failing because they attempted to use short term repo financing to carry long term assets like mortgages. If we ignore the pejorative connotation associated with the term "shadow", the non-banks that did what banks traditionally do could logically be called "shadow banks."

But although this might be a reasonable inference from what happened in the financial crisis, it is not the inference that the FSB chose to draw when it came to defining shadow banking. Thus, in 2012, it noted that

> "[E]xperience from the crisis demonstrates the capacity for some non-bank entities and transactions to operate on a large scale in ways that create bank-like risks to financial stability (longer-term credit extension based on short-term funding and leverage). Such risk creation may take place at an entity level but it can also form part of *a complex chain of*

[8] FSB, "Strengthening Oversight and Regulation of Shadow Banking," Consultative Document, November 18, 2012, p1

transactions, in which leverage and maturity transformation occur in stages, and in ways that create multiple forms of feedback into the regulated banking system." [9][emphasis added]

As the FSB sees it, then, many entities in the shadow banking world work together to produce the maturity transformation that is the risky element of traditional banking. Former Fed chair Ben Bernanke—a strong and persistent backer of regulating shadow banks—provided an example of what the FSB is getting at in a 2012 speech:

> As an illustration of shadow banking at work, consider how an automobile loan can be made and funded outside of the banking system. The loan could be originated by a finance company that pools it with other loans in a securitization vehicle. An investment bank might sell tranches of the securitization to investors. The lower-risk tranches could be purchased by an asset-backed commercial paper (ABCP) conduit that, in turn, funds itself by issuing commercial paper that is purchased by money market funds.[10]

The problem with this, Bernanke went on, is that "Although the shadow banking system taken as a whole performs traditional banking functions, including credit intermediation and maturity transformation, unlike banks, it cannot rely on the protections afforded by deposit insurance and access to the Federal Reserve's discount window to help insure its stability."

Thus, to the extent that Bernanke reflects the underlying ideas circulating in the FSB—a good bet given the importance of the Fed in the world's financial system—the effort to control shadow banking is based on the idea that while it can create risky maturity transformation it does not have the necessary access to either the deposit insurance or the Fed's discount window that protect shadow banks against runs.

For this reason, apparently, the FSB is considering how to designate shadow banks—as defined above—as "systemically important financial institutions," or SIFIs. Thus, in September 2013, the FSB announced that it is "reviewing how to extend the SIFI Framework to global systemically important nonbank noninsurance (NBNI) financial institutions." This category of firms, said the FSB, "includes securities broker dealers, finance companies, asset managers and investment funds, including hedge funds."[11]

This is troubling for two reasons. First, the persistent calls by bank regulators to get control of "shadow banking"—even before it had been defined—calls into question whether bank regulators are doing this because they honestly believe that shadow banking is a danger to the financial system, or because shadow banking is a serious competitive threat to the traditional regulated banking system. It is interesting to note that as early as 2009 the Group of 30—another organization of bank regulators and financial experts—called for the regulation of large nonbank systemically important financial institutions, including large pools of capital, well before the term "shadow banking" had become widespread.

The second reason is that if they are successful in controlling what the FSB has now defined as shadow banking—that is asset managers, securities firms, investment funds, finance companies

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[9] Ibid.

[10] Ben Bernanke, "Fostering Financial Stability," Speech at 2012 Federal Bank of Atlanta Financial Markets Conference, p2

[11] FSB, "Progress and Next Steps Towards Ending 'Too-Big-to-Fail,'" Report of the Financial Stability Board to the G-20, September 2, 2013, p17.

and hedge funds, among others—they may succeed in stifling the continued growth of the securities and capital markets in the United States, which have been far and away the main sources of financing for US business. Both the competitive problem for banks and the potential problems for continued economic growth in the US are illustrated in the following chart, which shows the growth of the capital markets in relation to banks over the last 50 years.

The FSB is serious enough about this idea to suggest in January of this year that asset managers with more than $100 billion under management could be designated as SIFIs. Since pension funds, bond funds, and mutual funds don't engage in maturity transformation on their own, this latest sally must come under the category of "*a complex chain of transactions, in which leverage* and maturity transformation occur in stages."

This could explain why the FSB is considering asset managers as SIFIs, although they do not engage in maturity transformation, and the funds they manage are completely different from the banks or investment banks that suffered losses in the financial crisis. When a bank or investment bank suffers a decline in the value of its assets—as occurred when mortgages and mortgage-backed securities were losing value in 2007 and 2008—it still has to repay the full amount of the debt obligations it incurred to acquire those assets. Its inability to do so can lead to bankruptcy. But if a collective investment fund suffers the same losses, these pass through immediately to the fund's investors. The fund does not fail and thus cannot adversely affect other firms. In other words, asset management cannot create systemic risks,[12] yet the FSB seems bent on including the largest firms in this industry among the SIFIs it will designate. And, as outlined above, the FSOC seems to be following this lead.

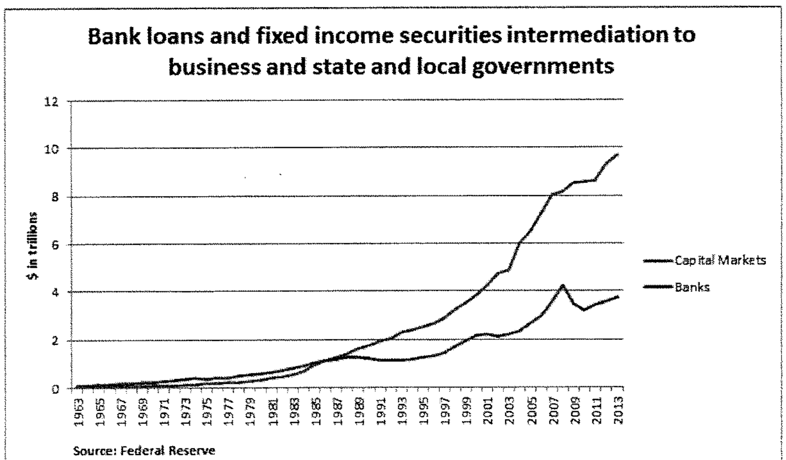
Members of the asset management industry have argued, correctly I believe, that if the Fed attempts to impose capital requirements on managed funds those funds would quickly lose their investors. But this does not mean that the Fed would have no interest in regulating them—if that would enable the Fed to control the nature and scope of their investment activities. As the supervisor of fund managers the Fed could prevent them from engaging in making investments that are part of a "complex chain of transactions" that results ultimately in maturity transformation. As noted earlier, Section 115 of the Dodd-Frank Act gives the Fed the authority to engage in prudential supervision of nonbank SIFIs, and that would mean controlling their risk-taking. In addition "risk management" is one of the specific areas that the Section 115 says the Fed can consider when it supervises a SIFI.

This point highlights an important fact about the FSOC's designation process: the Fed has not made clear what restrictions it would impose on the insurance companies that have already been designated as SIFIs, on the asset managers the FSOC is now considering for designation, or on the securities and capital market firms of various kinds that might be designated in the future. It will be impossible for Congress to determine the effect of these designations until the Fed has clarified what it actually intends to do when it has the power to impose what the Dodd-Frank Act calls stringent prudential regulation, and how it intends to interpret what is called the Collins amendment, which requires that SIFIs hold capital in some form. Accordingly, in addition to all the other reasons for the SIFI designation process to stop, there is the further reason that neither the FSOC nor Congress can assess what effect

[12] See, Peter J. Wallison, "Unrisky Business: Asset Management Cannot Create Systemic Risk," *Financial Services Outlook*, January, 2014.

designations will have on the US economy until the Fed has made clear what restrictions it intends to impose.

Nevertheless, even without knowing exactly what the Fed intends to do, it is clear that an effort by the FSB and the FSOC to designate members of the securities and capital markets industry as SIFIs could have a highly adverse effect on economic growth and jobs in the US. Over the last 30 years, the success and growth of nonbank financial institutions (again, what the regulators call shadow banking) have reduced the importance of banks, and thus the importance and regulatory latitude of bank regulators. In the chart below, we can see that since the 1980s the securities industry—more generally the capital markets—have outcompeted the banks for financing corporations and states and municipalities.



One of the reasons for this is probably the tighter regulation of banks. The additional costs have made banks uncompetitive as financial sources for firms that can raise funds directly in the securities markets. Another and probably more important reason is that commission-based intermediation is inherently more efficient than principal intermediation by a bank. The communications revolution that occurred in the mid-1980s allowed corporations to disseminate directly to investors the financial information they were filing with the SEC. With that information, investors and analysts could make their own judgments about credit issues, buying bonds, notes and commercial paper from, and paying commissions to, securities intermediaries. The traditional intermediary advantage of banks—that they had information about companies that no one else had or could easily get—disappeared. Once the information was available elsewhere, the principal intermediation of banks was simply too expensive. This made it more difficult for regulators to restrict bank activities, since that only weakened banks further in the face of capital markets competition. If the main competition for banks can be brought under effective regulatory control, bank regulation can become even tighter.

The effects of regulation

The dollar effect of regulatory restrictions cannot be calculated. That is one of the reasons that economists do not try to estimate the cumulative effect of Dodd-Frank on economic growth. But the effect can be seen in the results of individual financial firms. In March, for example, JPMorgan Chase, the largest US banking organization, cut back its projections for the coming year, saying that its trading profits and return on equity would be down. It noted that it would also add 3000 new compliance employees, on top of the 7000 it added last year. But the total employees of the bank are expected to fall by 5000 in the coming year.[13] So what we are seeing is that compliance costs are being substituted for the personnel that are normally the sources of revenue and profit.

Often, these negative reports are blamed on slow business growth or lack of consumer spending, but this may be confusing cause and effect. If JPMorgan Chase were not substituting compliance officers for calling officers, the calling officers would be out in the market talking to businesses and offering them credit for expansion.

If what the FSB called the "SIFI Framework" is in fact extended to the rest of the financial system through decisions of the FSOC, the regulatory sclerosis that is affecting banks will be extended to the rest of the financial system and then to the economy as a whole. We can anticipate that credit will become more costly, simply because securities and capital markets entities will be doing a variation of what JPMorgan Chase is doing—hiring more compliance officials and substituting them for employees that are profitable for the firm. If credit is more expensive, some firms will be priced out of the market; the cost of borrowing will exceed the profit that could be earned from the additional productive resources put in place. If there is less borrowing, there will be less firm expansion and less equipment installed that will increase productivity. All of this will mean less economic growth.

Less tangible losses will also occur. If large capital markets firms are placed under bank-like supervision, they will take fewer risks. This is because it is the inclination of regulators and supervisors to reduce risk-taking for fear that it will cause losses for which they will be blamed. Less risk-taking will mean less innovation, fewer new efficiencies tried and, again, slower growth. Yes, there will be fewer failures of financial firms, but at the same time there will be fewer new start-ups because there will be less credit for start-ups, which are riskier than established firms.

Finally, we have the problem of too-big-to-fail (TBTF). This is a serious problem in the banking industry, where we have a few gigantic banks that are considered SIFIs as well as more than two dozen others that were designated as SIFIs by the Dodd-Frank Act because they have more than $50 billion in assets. A SIFI designation is a statement by the government that the firm will not be allowed to fail because its failure could cause instability in the US financial system. That's what it means when the FSOC says that a firm's "financial distress" will cause "instability in the US financial system."

If the government will not allow a firm to fail, creditors will see it as a safer investment than other firms that do not have this designation, and as a result its cost of credit will be lower because it will be seen as less likely to fail. We do not know how to solve the TBTF problem in

[13] Dan Fitzpatrick, "J.P. Morgan Dims Its Light on 2014," *Wall Street Journal*, February 26, 2014.

the banking industry, but with SIFI designations for nonbanks we are going to create the same problem in other industries.

The SIFI designations that have already occurred in the insurance industry could create TBTF in insurance, where it has never been a problem before. This would be particularly acute in the insurance market, where competition is often about which is the safest insurer from which to buy coverage against various risks. A company that is designated by the government as TBTF will be able to attract business because it is unlikely that it will ever fail—a key selling point. In addition, insurers that have been designated as SIFIs might also be able to attract lower cost funding for the same reason that is true of the TBTF banks.

Thus far, TBTF has not been a problem in the capital markets. It has always been assumed that capital markets firms could fail. Indeed, they are supposed to be risk-takers while banks are supposed to be more cautious and safer. However, if SIFI designations begin in the securities and capital markets business it could bifurcate the market with firms that are seen as protected by the government having better and lower cost access to credit than firms that don't. This could eventually cause the kind of consolidation of the market that has happened in banking.

Or, it could work the other way. Barney Frank was fond of saying that if SIFI designation would make firms TBTF, why were so many firms fighting it? The answer is that no firm knows what kind of regulatory costs they will face once they have been designated as a SIFI. The costs could far outstrip the benefits. But from a policy perspective that would not be good either. It would mean that these large SIFI firms would not be able to compete effectively with their more nimble and less regulated competitors. In that case, we would end up with a lot of firms in "financial distress" that the government has said will create "financial instability" if they fail. One thing is clear: it will never happen that the benefits of being TBTF are exactly matched by the detriments of regulatory costs. One or the other will be the outcome, and neither is acceptable as a matter of policy. One way or the other, we will have made a huge mistake if we allow the largest firms in the nonbank financial industry to be designated as SIFIs and thus regulated like banks.

Conclusion

Congress should be wary of the FSOC's extraordinary discretionary authority. This authority is the result of a misperception that the financial crisis was caused by insufficient regulation of the financial community. The Dodd-Frank Act was the result. The actual cause was the US government's housing policies. Nevertheless, if Dodd-Frank can't be repealed at this point, Congress should at least have an opportunity to consider the effects of SIFI designations before they are made. The potential adverse effects of these designations are too important to be left for consideration by regulators, who are eager to extend their control over the financial system.

Despite the apparent appetite of both the FSB and the FSOC for placing what the FSB calls a "SIFI Framework" over "shadow banking," –asset managers, mutual funds, securities firms and hedge funds, among others—there is no indication that these entities had any role in the financial crisis. Instead, these firms have been the key organizations that have financed

American business over the last 30 years, and subjecting them to bank-like prudential regulation could do serious damage to the US economy.

Your recent request, Mr. Chairman, that FSOC "cease and desist" any further designations until Congress has an opportunity to consider the consequences for the economy, should be recognized by the FSOC as reasonable—and obeyed. If it is not, Congress should consider repealing the authority of the FSOC to designate SIFIs and to release from Fed regulation and supervision the firms that have already been designated.

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Systemic Risk and the Asset Management Industry

Douglas J. Elliott, Fellow, The Brookings Institution

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The recent devastating global financial crisis has focused policymakers on sources of risk to the financial system that could have spillover effects on the economy as a whole. This search for "systemic risk" has ranged widely, going well beyond the banks that are at the heart of the financial system to include, among others: finance companies and other near-banks; insurers; financial utilities, such as clearing houses; various financial instruments such as derivatives and securitizations; financial market practices such as the use of repurchase agreements; and the asset management industry and its practices.

This paper will explore systemic risk in the asset management industry and the appropriate response by U.S. regulators. This is a particularly important area, given the huge volume of assets under management, estimated at as much as $53 trillion.[1]

Reference will be made from time to time to a report by the Office of Financial Research of the US Treasury Department (OFR) that was issued in September 2013 entitled "Asset Management and Financial Stability". The Financial Stability Oversight Council (FSOC) had requested the OFR to study the asset management industry and its practices and their relationship to financial stability issues. The FSOC is a council of the top U.S. financial regulators and is charged with watching over the stability of the U.S. financial system. The Dodd-Frank Act that created the FSOC gave it, and the financial regulators that comprise it, very substantial authority to act to force changes that reduce systemic risk, if they believe it to be necessary. Choices made by the FSOC could have major effects on the asset management industry. Not surprisingly, the OFR report has gained considerable attention, despite its status as solely an initial background report for the FSOC's use.

This paper will tackle the questions surrounding the potential for systemic risk to arise from, or be amplified by, the asset management industry and its practices. It will focus on the following questions:

- What is systemic risk
- How is systemic risk measured?
- What are asset managers?
- What types of asset managers exist and how do they differ?
- How do asset managers touch systemic risk?
- In what ways do asset managers create or amplify systemic risk?
- How should the FSOC reach a decision about SIFI designation?
- Should the FSOC designate any asset managers as SIFIs?
- How could the Fed supervise asset managers designated as SIFIs?

This is a large and complex topic, so the paper will necessarily be an introduction to the key issues rather than providing detailed, definitive answers.

The Economic Studies Program at the Brookings Institution, of which I am a fellow, held a conference on December 16, 2013 in which we explored the OFR report and the larger questions of systemic risk in asset management. A number of leading thinkers gave their views, including Richard Berner, the Director of the OFR. I was both a moderator and a panelist and have drawn on my remarks in writing this paper. A transcript, and the PowerPoint slides from most of the presenters, are available at www.brookings.edu/events/2013/12/16-systemic-risk-asset-management-industry

Before addressing these questions, it is worth emphasizing a viewpoint of mine that is often ignored in previous analyses. It is important that the *net* systemic risk created by the asset managers be considered in SIFI designation. It would be inappropriate and ineffective for asset managers to be viewed as responsible for actions that are essentially just the passing through of end-investor decisions. However, if it is true that asset managers are increasing the systemic risks or creating new ones, then it would indeed be appropriate to consider that *net* increase in systemic risk in the designation decision.

It is important that the *net* systemic risk created by the asset managers be considered in SIFI designation. It would be inappropriate and ineffective for asset managers to be viewed as responsible for actions that are essentially just the passing through of end-investor decisions.

One might argue that it may be appropriate to regulate asset managers even if they simply transmit risk. One could create restrictions to reduce systemic risk, essentially using the convenience of asset managers as entities that can be regulated to deal with risks that arise from the underlying investors. For example, one might limit their ability to engage in fire sales in some manner. However, I believe this type of approach would be a mistake. It is likely to push investors' money into channels that are not restricted in this way, dampening socially useful asset management activities and creating new regulatory risks. Mutual funds, for example, have worked quite well over the years as part of the U.S. financial system and they operate under many constraints to protect investors. It would be a shame if a large part of their assets moved to channels with fewer regulatory constraints and less history by which to judge them.

What is systemic risk?

There is no single agreed definition of systemic risk, but it refers generally to the risk that the financial system as a whole, or important parts of it, seize up in a crisis and cease temporarily to perform effectively their key economic functions. The clearest manifestation of this risk is probably a credit crunch that results from the failure of one or more banks, reducing the ability and willingness of the banking system to supply needed loans to the economy at a reasonable price. However, systemic risks could arise outside of the banking system and then hit the wider economy through damage caused to the banks or by directly affecting financial markets or other non-bank credit providers.

There simply is no agreed definition of systemic risk and even less agreement about how to measure it. The disagreement stems at core from the lack of an agreed model of the financial system and its interlinkages with the wider economy.

While the FSOC acknowledged in its 2011 annual report that there is a lack of a commonly accepted definition, it also stated that "all definitions attempt to capture risks to the stability of the financial system as a whole, as opposed to the risk facing individual financial institutions or market participants."[2] This concept is apparent in the definition applied by Bisias et al (2012) in their survey of systemic risk analytics: "any set of circumstances that threatens the stability of or public confidence in the financial system."[3, 4] A similar, albeit slightly more expansive definition, is used by the European Central Bank in defining it as a risk of financial instability "so widespread that it impairs the functioning of a financial system to the point where economic growth and welfare suffer materially."[5]

Appendix A contains a fuller discussion of the varying definitions of systemic risk.

How is systemic risk measured?

Ideally, we would be able to measure the level of systemic risk at a given point in time and then determine what the level would be if certain policy changes were made. Further, it would be useful to allocate the total risk in the system to individual institutions or market functions. The latter would be particularly helpful for the FSOC in fulfilling its legal mandate to spot systemically important financial institutions that would then be subject to more supervision and regulation.

A number of researchers have attempted to quantify systemic risk. However, there is a great deal of controversy about the methodologies and results. In a methodological survey conducted by Bisias et al (2012) for the Office of Financial Research, no less than thirty-one different methods of measuring systemic risk are identified; yet even this extensive survey is caveated as not being "exhaustive in...breadth."[6] Indeed the diversity of sensitivities and aspects of financial stability being covered by each model lead the authors to raise the point that "a single consensus measure of systemic risk may neither be possible nor desirable."[7]

Appendix B contains a detailed discussion of the major approaches to measuring systemic risk. The key point for this paper is that there simply is no agreed definition of systemic risk and even less agreement about how to measure it. The disagreement stems at core from the lack of an agreed model of the financial system and its interlinkages with the wider economy. This leaves analysts with quite varying views of the core vulnerabilities of our financial system, which leads to differing measurement approaches focused on different types of risk.

The difficulties in agreeing on a definition and measurement approaches for systemic risk make it considerably harder to find common ground on the question of how to measure and regulate systemic risk in the asset management industry.

What are Asset Managers?

Asset managers, broadly defined, provide investment management services as fiduciary agents for clients. Asset managers generally do not invest on their own account. This distinguishes the business model of asset management from those of other financial institutions. Commercial banks, investment banks, insurers, and government-sponsored credit providers all engage in activities that involve substantial balance sheet risk. Most notably, financial intermediaries, such as banks, fund themselves with deposits and borrowings in the market and then make loans or buy investments where the risk and reward accrue to the intermediary. As another example, investment banks serve as principals in their trading and market-making activities, risking their own capital in financial transactions.[8] In contrast, as agents, asset managers invest on behalf of their clients; that is, the losses and gains from their investments accrue to the clients as opposed to the firms.[9]

In fulfilling the core function of investing cash for clients, asset management firms engage in a variety of activities, which can be categorized into two groups: those that occur at the fund level and those that occur at the management company level. Fund level activities include overall asset allocation, selection of specific securities, and liquidity management. Fund shareholders receive any profits or losses. Management company activities include administration, centralized execution of trades,

risk management, and market research. There are interconnections between the two levels. For example, management companies may provide their funds with lines of credit in order to cover investor redemptions; such lines may allow the funds flexibility to keep less cash on hand.

Another notable feature of asset management is the revenue structure. Unlike banks, asset managers receive little or no income from investments. Their primary revenue source is from fees for services, particularly the core fee for managing assets.[10] This not only creates a relatively stable income stream, but also leads to smaller balance sheets at the management company level, with relatively little debt on them.[11] Private funds, such as hedge funds, are a partial exception to this rule, as they are not subject to restrictions on receiving performance fees, which gives the management company a direct stake in the performance of the funds.

Another critical difference between asset management and commercial banking is that asset management firms do not rely on government support in the same way that commercial banks do. In the United States, bank deposits are guaranteed by the Federal Deposit Insurance Corporation, which has a credit line with the US Treasury and a strong implicit government guarantee. Asset managers however, must explicitly disclose to clients that investment performance, and the original principal invested, are not guaranteed by any entity.[12]

What Types of Asset Managers Exist and How Do They Differ?

Some asset managers exist within independent investment companies while others may be divisions of insurers, banks, or other entities. Asset managers may operate mutual funds or other types of co-mingled funds or they may operate separately managed accounts for individuals and institutional investors. There are a wide variety of specific asset management models. In this section, five specific types of funds will be highlighted and discussed: Mutual Funds, Exchange-Traded Funds, Collective Investment Trusts, Separate Accounts, and Hedge Funds.

The Securities and Exchange Commission (SEC) offers the following definition of mutual funds: "a type of investment company that pools money from many investors and invests the money in stocks, bonds, money-market instruments, other securities, or even cash."[13] Investors, or their brokers, purchase shares in mutual funds directly from a fund, but may not purchase shares on secondary markets, such as the New York Stock Exchange. A mutual fund's share price is equal to the fund's approximate net asset value (NAV) – the value of an investment company's total assets less its total liabilities[14] divided by the number of outstanding shares. Each fund must re-calculate its NAV at the end of each trading day, though some funds do so more frequently. Mutual funds are considered "open-end" investments, meaning that shareholders are free to buy or redeem shares on any day. While mutual funds come in a wide variety depending on, among other things, risk profile, asset class focus, and investment strategy, some common types include: money market funds, which are legally required to invest in short-term, low-risk securities; equity funds, which invest principally in stocks; and fixed income funds, which invest primarily in bonds and other types of debt securities.

Like mutual funds, exchange-traded funds (ETFs) enable investors to pool their money in a fund that invests in stocks, bonds, or other assets, and earn a corresponding return. Unlike mutual funds however, ETF shares are traded on national stock exchanges at market prices that may not necessarily reflect the NAV of the fund. While ETFs were initially designed to track the performance of specific U.S. equity indexes, such as the S&P 500, newer funds may track indexes for other financial securities or may be actively managed and based on complex investment strategies.[15]

Collective Investment Trusts (CITs) are similar to mutual funds in that they enable investors to combine their assets in order to achieve a larger and more diversified portfolio. But unlike mutual funds, CITs are only eligible for qualified retirement plans, such as 401(k) plans and government plans.[16] Furthermore, CITs are not regulated by the SEC. Instead, CITs are managed by banks or trust companies and subject to regulations enforced by the Office of the Comptroller of the Currency. In practice, CITs face less stringent reporting standards and have lower costs.[17]

A Separately Managed Account (SMA) is a portfolio of assets under the management of a professional investment firm. SMAs have higher investment minimums than mutual funds and are targeted at wealthier investors. In contrast to mutual funds, each account has a customized investment portfolio to fit the client's unique investment objectives. Thus the primary difference between SMAs and other pooled investment vehicles, such as mutual funds, is that decisions are made at the account level and will not affect all fund investors in the same way.[18] That said, smaller separate accounts are often managed with a set of common approaches, in order to gain some economies of scale.

There is no universally accepted definition of hedge funds. In general, hedge funds are a type of private fund that have few restrictions on the types of investment activities that they engage in.[19] Private funds are excluded from registration requirements under the Investment Company Act of 1940, and differ from registered funds in a variety of ways, such as in their freedom to use leverage without limit and impose

restrictions on investor redemptions.[20, 21] Investors in hedge funds must be accredited, meaning that they fit certain minimum wealth standards, and typically include institutional investors, such as pension funds and insurers, and high net worth individuals.[22, 23] Hedge funds tend to be less liquid than other types of funds such as ETFs or mutual funds.

How do asset managers touch systemic risk?

Asset managers control the investment decisions for a substantial percentage of the total assets invested in financial markets. This particularly matters in the U.S. because of the relative importance of financial markets, as compared with more bank-centric financial systems in most of the rest of the world, including Europe, Japan, and China. A crisis in the financial markets can harm the real economy through multiple channels:

Credit supply. Crises cause a substantial contraction of the supply of credit and equity funding, reducing economic growth.

Wealth effects. Crises also create a significant decline in household wealth with the attendant reduction in spending and slowdown in the economy.

Confidence effects. Crises damage consumer and business confidence, leading to lessened business activity and employment.

Links to the bank sector. Problems in the financial markets can be transmitted to the banks with which markets are interlinked in a number of different ways, including by reducing the value of bank assets and capital and by tightening bank liquidity conditions by making it difficult to sell certain assets at a reasonable price.

Liquidity effects. Money market funds have been a partial substitute for bank deposits and a "run" on such funds could have effects on the economy similar to a bank run, forcing fire sales, blocking credit channels, and harming confidence. Some analysts are concerned that other asset management activities could have similar attributes.

Decisions by asset managers affect, or are affected by, these systemic risks principally through two related channels: asset prices and liquidity conditions in financial markets. Asset managers decide what volumes of specific assets they are willing to buy or sell and at what prices. These decisions are partly a result of analysis by the managers and partly a response to financial market conditions and, importantly, inflows and outflows of funds from their investor clients.

One risk related to asset management is the potential for large-scale redemptions from funds during times of market stress. Unwinding positions during turbulent periods may require conducting costly and unprofitable trades. This risk would be exacerbated if investors believe that they will gain an economic advantage by being the first to redeem.[24] There has been such an advantage to some extent for money market funds because of the artificial use of a Net Asset Value of $1.00 per share even when the actual NAV is slightly above or below that amount. In such a situation, the costs of trades in troubled markets could primarily be borne by the remaining investors, creating a "first-mover advantage" to withdrawing funds.[25] The presence of a "first-mover advantage" may distort investor expectations and serve as a source of risk to a fund.[26]

In general, redemptions on a scale that threatens financial stability or that triggers heavy selling and price declines in markets have not been observed. According to analysis conducted by the Investment Company Institute, "investors do not redeem heavily from stock and bond funds during periods of market stress and fund portfolio managers are not heavy sellers of portfolio securities in down markets."[27] Nevertheless, redemption risk remains a concern for asset managers and regulatory authorities insofar as it is presents a legitimate channel through which funds may be exposed to financial shocks.

Securities lending programs serve as another channel through which asset managers may touch systemic risk. During the financial crisis, some asset managers that were involved in securities lending programs bore significant losses on cash collateral that had been invested in assets that were severely impacted by the crisis, such as structured investment vehicles and Lehman Brothers notes.[28] Moreover, securities lending programs create another source of redemption risk. Borrowers may seek to return securities if they are concerned about the safety of their collateral in stressful market periods. Since asset managers typically reinvest cash collateral in money markets, in the event that markets have seized up and borrowers demand the return of their collateral, lenders may be forced to sell at a loss assets that have become illiquid in order to return the cash collateral.[29]

Asset managers may also touch systemic risk through interconnections with other financial institutions or business lines. According to the OFR, the complex network of interconnections among asset managers and other financial services firms may expose asset managers to risks that arise in other market sectors.[30]

> The relative importance of financial markets in the United States compared to the bank-centric financial systems of the rest of the world means asset managers play a critical position in managing systemic risk.

[31] Likewise, asset managers may be exposed to risks through interconnections within their own firm or fund complexes. Asset managers that work in a division of a bank or insurance company or that work in an asset management company that offers ancillary services, such as in-house broker-dealers, commodity pool operators, trust companies, or consulting services, may be exposed to risks in other market segments.

Asset managers act autonomously in many ways and in others act solely as agents passing through the decisions of their investors. Therefore, it is important in considering systemic risk to separate out the impacts on risk arising from the structure of asset managers and their decision-making processes from those that merely represent the pass-through of decisions by their customers. It will generally be ineffective to try to reduce systemic risk at the asset manager level in those cases where the real determinants are decisions by end-investors. That is, the distinction must be made between *exposure* to systemic risk, as has been discussed in this section, and *creation or amplification* of systemic risk.

It will generally be ineffective to try to reduce systemic risk at the asset manager level in those cases where the real determinants are decisions by end-investors. That is, the distinction must be made between *exposure* to systemic risk and *creation* or *amplification* of systemic risk.

In what ways do asset managers create or amplify systemic risk?

It is critical to determine whether the existence of an asset manager causes the total level of systemic risk to be significantly higher than it otherwise would be. This should exclude the effects of simply pooling together systemic risks that would otherwise exist, unless there is an amplification effect caused by the act of pooling.

Some read the OFR report to imply that asset managers can create systemic risk by entering into fire sales of troubled asset categories in a time of crisis. A "fire sale" is the sale of an asset at a price below its value that takes place because it is forced in some manner, rather than as the result of a discretionary investment decision that happens to undervalue the asset.

It is not clear that this implication was intended by the OFR, but if it was, the key question is whether such fire sales are simply a straight pass-through reflecting choices by end-investors. For example, if mutual funds dumped tech shares during the Tech Crash of 2001, but did so simply by proportionally lowering the size of their holdings in response to investor redemptions from the mutual funds, then it does not seem meaningful to view the asset managers running those funds as having created the fire sales.

Thus, asset managers do not bring a fire sale risk unless their mode of operation makes such risks higher than would exist simply due to the changing preferences of their end-investors. This would hold even if the end-investor choices are themselves the result of fire sale conditions. That is, if end-investors want or need to dispose of assets quickly, for whatever reason, this would be reflected in overall financial market conditions whether those investors owned the assets directly or did so through an asset manager.

It is theoretically possible that having large amounts of assets pooled together under one asset manager could raise the risk of fire sales, because of an amplification effect. For example, if millions of end-investors entrust their funds to the management of a single asset manager, it is possible that the manager would concentrate their investments in a few assets and create fire sale risks for those assets that would be more severe than would have existed if the end-investors had acted independently or had spread their money across more managers. Of course, higher concentration in an asset at a given manager might be offset by lesser holdings at another manager. For this theoretical risk to exist in reality, it would have to be true that asset managers, as a class, "herd," or create greater concentration in specific assets, or that asset managers with high concentrations in specific assets are more prone to forced sales.

There is an extensive body of theoretical and empirical literature on institutional herding. Institutional investors may exhibit herding behavior for a number of reasons, some of which do not apply to retail investors, including information cascades – that is, inferring information from one another's trades,[32] relying on similar information or market signals to make investment decisions,[33] the possibility of reputational costs to investing against the crowd,[34] or the presence of competitive pressures.[35] While there is empirical evidence suggesting that institutional investors broadly may exhibit herding behavior, thereby increasing market concentration in specific assets or asset classes, such is not necessarily the case for every type of institutional investor. Mutual funds as a class, for example, tend to exhibit less herding behavior.[36, 37]

As to whether asset managers with high concentrations in specific assets are more prone to fire sales, the OFR argues that if asset managers assume large or concentrated market positions, the "likelihood and severity" of fire sales could increase. The OFR explains that this risk is particularly pronounced in markets that have high barriers to entry or that tend to be populated by specialized funds, since such markets have a "lack of substitute investors" and are thus less liquid. In the event that a fund with a concentrated position in

such a market needed to raise cash - to, for instance, cover redemptions - they would be vulnerable to high liquidity premiums and more likely to have a large price impact from selling.[38] The extent to which there might be negative externalities from such a situation would be determined by various other factors, such as the firm's degree of leverage and linkages to other financial institutions.[39] Again, it will be critical to judge the extent to which this excessive concentration is the result of the existence of the asset managers as opposed to end-investor behavior that flows through the funds. If one type of asset becomes the flavor of the month for end-investors, this will be reflected in asset manager choices.

With respect to the issue of whether large asset management firms create a discrete risk by nature of their size, the OFR does take the position that the distress or failure of an asset management firm "could be a source of a risk, depending on its size," in addition to other factors.[40] If a large firm were forced to sell assets, the report explains, asset valuations could be depressed or market volatility could increase, creating the potential for spillover effects. The OFR further argues that "material distress" at the management company level could threaten "a broader loss of confidence" in financial markets.[41]

Funds that employ financial leverage could also create or magnify systemic risks. Levered entities are subject to margin calls and haircuts from creditors, exposing them to the risk of fire sales during episodes of market stress. Moreover, leverage serves to magnify any losses that occur on bad investments. Asset managers can obtain leverage through traditional bank loans or other borrowings or can create similar exposures through derivatives or securities lending or repurchase agreements. There are a number of regulatory limitations on the extent to which registered funds can obtain leverage,[42] and, the "typical mutual fund" has been used as an example "of a nonbank financial company with a low degree of leverage."[43]

> Two types of funds have been highlighted in the systemic risk discussion: hedge funds and exchange-traded funds.

Beyond industry-level risks related to herding, redemptions, fire sales, and leverage, two types of funds have been highlighted in the systemic risk discussion: hedge funds and ETFs.

With respect to the former, hedge funds face fewer regulatory restrictions on their activities than registered funds, such as mutual funds. As a result, they may use leverage without limit, impose restrictions on investor redemptions, face no restrictions on investment strategies, and are exempt from many regulatory oversight and reporting requirements.[44] Nevertheless, according to Dixon, Clancy, and Kumar (2013), hedge funds did not play a "pivotal role" in the recent financial crisis, and while they may "contribute to systemic risk" and ought to be closely monitored, in the authors' estimation they "need not be the primary concern of regulators as they work to improve the stability of the world's financial system."[45] The OFR report touches on the issue of private funds and systemic risk, but does not go in detail, as further analysis on the topic will be conducted by regulators in conjunction with information currently being gathered in the newly instituted Form PF (Private Funds).

ETFs, like other closed-end funds, offer intraday trading of shares. Although the majority of ETF assets are invested in highly liquid equity markets, investors also use ETFs to gain exposure to less liquid market segments, such as fixed income and emerging market securities.[46] Intra-day trading, and the inability for investors to redeem at NAV, raises some issues that concerned the OFR.

The OFR has stated that ETFs "may transmit or amplify financial shocks" that have originated elsewhere in the system. While trading in ETF shares may offer the benefit of improving price discovery by providing a market price for a portfolio of investments in thinly traded markets, the report goes on, it could also "amplify ... price movements ... during market turbulence."[47] However, beyond raising these concerns and discussing the behavior of ETFs in two notable cases -the Flash Crash and the market turbulence of June 20, 2013, the OFR does not cite any empirical research showing that ETFs may amplify financial shocks, exacerbate adverse price movements, or lead to market volatility.

A key question in regard to this argument is whether ETFs "transmit" financial shocks or "amplify" them. The OFR report does not specify an answer to this key distinction. There is a reasonable argument that fire sales related to ETFs would have occurred directly through the mechanism of sales of the underlying assets, if ETFs did not exist. It is even possible that by placing liquidity risk on those who are buying or selling the ETFs, rather than pooling it across all participants in the fund, there is a reduction in the systemic risk that some argue comes from incentives for fundholders to exit first in the event of a panic.

At this point, it is not clear whether ETFs amplify financial shocks. This is likely to depend to a significant extent on whether ETF holders understand the actual degree of liquidity available to them to the same extent that holders of the underlying assets do. (This could be a weak understanding in either case, of course.) One concern is that it is possible that holders of ETFs take too

much comfort from the ability to trade easily over the course of the day in normal times.

How should the FSOC reach a decision about SIFI designation?

The Financial Stability Board (a global coordinating body for financial stability issues) and the International Organization of Securities Commissions (IOSCO) have proposed the following indicators of systemic risk for asset managers. (The short descriptions are my own summaries.)

Size. All else equal, a larger firm or fund will have more potential impact on the financial system than a smaller one.

Interconnectedness. The more connections a firm has with others, the more channels there are to transmit problems.

Substitutability. If a firm provides an important service that is difficult or impossible to replace then problems at that firm can have wider repercussions.

Complexity. Complexity and the related opacity can breed panic in a financial crisis.

Cross-jurisdictional activities. Activities that cross boundaries can be harder to track and more difficult to clean up if problems develop.

There are good reasons to consider these factors, but it is impossible to know how to calibrate these measures without an analysis of the business models of the firms and their relationship to systemic risk. It is for this reason, presumably, that the FSOC asked the OFR to analyze the asset management industry. The OFR focused on "four key factors that make the industry vulnerable to financial shocks." These are, in the OFR's words:

> We could create restrictions on systemic risk created by end-investor decisions, but I believe this type of approach is likely to push investors' money into channels that are not restricted in this way, dampening socially useful asset management activities and creating new regulatory risks.

- "reaching for yield" and herding behaviors
- redemption risk in collective investment vehicles
- leverage, which can amplify asset price movements and increase the potential for fire sales
- firms as sources of risk

The OFR stated that there were two key channels by which these vulnerabilities could be transmitted to the wider financial system: "disruptions in markets caused by fire sales, and exposures of creditors, counterparties, and investors."

These are reasonable starting points for an analysis of asset managers and systemic risk, *if properly evaluated*. Assuming the FSOC accepts this view of the asset management business model and the risks it presents to the financial system, it will be important that the *net* systemic risk created by the asset managers be considered. As noted earlier, it would be inappropriate and ineffective for asset managers to be viewed as responsible for actions that are essentially just the passing through of end-investor decisions. However, if it is true that asset managers are increasing the systemic risks or creating new ones, then it would indeed be appropriate to consider that net increase in systemic risk.

One might argue that it may be appropriate to regulate asset managers even if they simply transmit risk. One could create restrictions to reduce systemic risk, essentially using the convenience of asset managers as entities that can be regulated to deal with risks that arise from the underlying investors. For example, one might limit their ability to engage in fire sales in some manner. However, I believe this type of approach would be a mistake. It is likely to push investors' money into channels that are not restricted in this way, dampening socially useful asset management activities and creating new regulatory risks. Mutual funds, for example, have worked quite well over the years as part of the US financial system and they operate under many constraints to protect investors. It would be a shame if a large part of their assets moved to channels with fewer regulatory constraints and less history by which to judge them.

Further, it will be critical to choose the right units of analysis, in particular to decide when an asset management company should be the entity evaluated and when it should be the group of funds managed by that manager or each individual fund. This is not straightforward. For many purposes it may be most appropriate to look at each fund within a fund family separately, since they are usually legally separate from their sister funds and cannot provide financial assistance across the funds. This is the preliminary choice made by the FSB/IOSCO. But, for potential fire sale effects, it may be relevant that an asset manager's research is used by multiple funds within the group, depending on the extent to which analysis at the manager level causes very similar actions to be taken by multiple funds.

Another important judgment call is on the degree of probability necessary to take a theoretically possible risk into account. To take an extreme, it is theoretically possible that the CEO of a large fund complex would find a way to embezzle all the funds managed by the asset manager. There are multitudes of safeguards to keep this from happening, but one could conceivably hypothesize a scenario in which this happens. Yet no one would suggest that SIFI designation should be affected by this truly remote possibility. On the other hand, something which is unlikely, but which has occurred in

the past and could plausibly occur again, might well be appropriate to consider. For example, it would have been appropriate pre-crisis to consider a scenario in which house prices fell nationwide, affecting many securities simultaneously, even though such a thing had not occurred since the Great Depression.

It is also worth emphasizing the importance of leverage as a systemic risk factor in the context of "shadow banking". Authorities around the world are worried that the increased burden of regulation on banks and other highly regulated financial intermediaries will cause substantial amounts of business to move to less regulated entities while retaining their essential characteristics. The exact nature of these characteristics is subject to debate, but certainly center around credit intermediation performed with high levels of leverage. (Many banks and insurers have ratios of assets to capital of 10:1 or more, making them much more levered than non-financial firms and than the large majority of funds managed by asset managers.)

Asset managers will certainly undertake activities that substitute for traditional credit intermediation, such as managing the many funds that already exist that invest in bank loans. (More basically, the bond markets can be viewed as a form of disintermediation and asset managers are major investors in bonds.) Some of the asset managers, particularly in the hedge fund world, will take on leverage to raise their returns from credit intermediation. High levels of leverage combined with credit intermediation, particularly if coupled with maturity transformation (borrowing short-term and investing long-term) are potential indicators of substantial systemic risk. (Note that the OFR report includes "redemption risk" as a key variable. This is essentially the fund management version of the risk from maturity mismatches.)

It should be noted that there is no decision factor here for whether SIFI designation would be the best regulatory approach. Dodd-Frank essentially assumes that any financial firm that presents a sufficiently high level of systemic risk should be designated as such and that the Federal Reserve will make appropriate choices about supervisory actions, if any, afterwards. Some argue that designation, of itself, can be harmful, such as by implying government support or by creating regulatory uncertainty about the firms. Whatever the validity of these arguments, Dodd-Frank did not give weight to them.

Should the FSOC designate any asset managers as SIFIs?

With the possible exception of money market funds, which are a complex topic, it seems unlikely to me that any US asset managers currently deserve to be designated by FSOC as SIFIs. To be fair, it is impossible to be completely certain of this without more information than is publicly available now. However, even the largest asset managers do not appear to cross the threshold of systemic significance, given that the bulk of their activities are undertaken as agents. As a preliminary overview, here are some thoughts on the key factors raised by the FSB/IOSCO and by the OFR.

Size. Some fund families in the US are very large, with as much as $2.5 trillion in assets in the largest funds management group, which is probably the principal reason that they might be considered formally for SIFI designation. However, if the correct unit of analysis is the individual fund, as would primarily be the case and as is preliminarily recommended by FSB/IOSCO, we see much smaller figures, with the Vanguard Total Stock Market Index Fund the largest, at a bit over $300 billion.[48]

Interconnectedness. Funds managed by the asset managers are at least loosely connected with many firms by owning their securities. They also have tighter connections with a smaller number of major financial institutions through securities lending, repurchase agreements, and derivatives exposures and similar counterparty relationships. They may also be affiliated with or owned by other financial firms. The interconnections with financial institutions bring the potential for transmitting systemic risk from asset managers, if significant risk does reside with the managers.

Substitutability. The great bulk of asset management activities could easily be moved to another firm. There are doubtless some specialized niches where this is not true, but even in the aggregate they are unlikely to be large at any particular firm. On the whole, ready substitutability in the industry argues against SIFI designation.

Complexity. Most asset management is performed in a straightforward manner and mutual funds and other registered investment companies provide a great deal of information about their activities. There will be exceptions to the complexity point, particularly at some hedge funds, but complexity is not a major issue overall in asset management.

Cross-jurisdictional activity. Some US asset managers do invest significant amounts overseas on behalf of their clients, but the great bulk of money is still invested in the US. Further, the types of activity are quite straightforward, such as buying foreign securities, and do not raise the concerns that caused this category to be included when considering financial intermediaries.

Moving on to the OFR vulnerabilities list:

Reaching for yield and herding behaviors. There is considerable evidence that asset managers exhibit herding behavior, including reaching for yield.[49] It is much less clear that this occurs to a greater extent than

would have been done by the end-investors themselves. In my view, it is easy to overstate the systemic risk from this aspect of asset management behavior and the total *net* risk from this is likely small compared to the size of assets invested.

Redemption risks in collective investment trusts. This depends heavily on the entity under consideration. In no case is the underlying systemic risk in asset management from redemption risk nearly as bad as the underlying run risk at financial intermediaries. Traditional bank runs are a particular problem because deposits that can be withdrawn on demand are used to fund multi-year, illiquid loans. The closest that asset management comes is with money market funds, which can normally be withdrawn on a day's notice and which some customers view as essentially the same as bank deposits, therefore effectively riskless. As a result, many of them appear to rely on the ability to withdraw funds quickly and without loss, in the same manner as a bank account, creating the possibility of runs if these expectations seem at risk of being thwarted. However, the maturity mismatch is far less severe than with traditional banking, as the average maturity of the investments of money market funds is measured in days, not years, and the average credit quality and liquidity are considerably higher than for loans. This means that the losses from a run on money market funds would be much less.

Beyond money market funds, there is also the saving grace that investors who use asset managers know that they can lose money, unlike with bank deposits where there is an expectation of safety. To the extent that investors fully recognize the liquidity risks, it is not clear that collective investment vehicles create any significant new systemic risk that would not have existed for the end investors if they had invested directly. It is true that there is an incentive to exit early in a crisis, in order to avoid the full impact of fire sales and overall worsening liquidity. However, this is just as true for those investing directly. Further, this assumes that investors recognize that things will keep getting worse, rather than choosing to hold out until potentially temporary problems reverse, as they often do.

Therefore, the place to focus on redemption risks is with those vehicles where there may be a substantial difference between investors' perceptions of liquidity and the reality. This is one of the main concerns with ETF's, since it may be the case that some investors are lulled into an assumption of permanent liquidity availability just because it is readily available, at low cost, in normal times. This is an area where more study is warranted.

Leverage. There is little leverage employed in most of the asset management industry, particularly registered investment companies, such as mutual funds. Statutory and regulatory limits provide assurance that this will remain true. Hedge funds, on the other hand, range in their approaches from ones with little or no leverage to others with much more. As a general matter, higher leverage is associated with lower risk in the underlying assets, since someone has to be persuaded to loan the fund money or to take the credit risk in some other way and they are understandably leery of multiplying the risks of leverage and high risk investments. Also, high-risk investments tend to provide a large enough absolute return to reduce the temptation to lever up excessively. Leverage is certainly an area to be considered closely when evaluating individual firms for potential SIFI designation, but it does not appear to be a huge factor for the industry as a whole.

Firms as sources of risk. It is true that one can imagine problems with an asset management company that would create contagion across all of the funds managed by that firm. However, it is not clear whether this is a realistic fear, at least on a scale that would cause systemic problems. Fund investors appear to be stickier than one might intuitively assume. Further, the ability to switch funds to another investment manager with ease greatly mitigates the potential damage. Thus, the firm risk is unlikely to surface unless the other elements that create systemic risk, such as high leverage, are already present. In sum, FSOC should consider this risk, but should be careful not to overweight it, as it is unlikely to be a major factor.

How could the Fed supervise asset managers designated as SIFIs?

If an asset manager were to be formally designated as a SIFI, there would then be a difficult question as to how the Fed ought to exercise its supervisory responsibility that would arise from the designation. Dodd-Frank was written with a strong emphasis on classic financial intermediaries such as banks and therefore focused on issues such as capital requirements that may be less relevant for asset managers.

The Fed would certainly want substantial amounts of information about the situation and activities of the designated entities and, to a lesser extent, related parties. It is unclear what additional information would be desired beyond what may already be reported publicly. It would likely encompass information about investment procedures and might go on to more detailed information about investment positions and trades.

This would serve both to give the Fed, and potentially other relevant authorities, the ability to monitor the risks within the overall financial system and would also increase the probability of spotting dangerous practices that might arise over time. It is difficult for an analyst such as myself to argue against additional information, but it must be borne in mind that there are costs as well as benefits to data collection, therefore a balance must be found. Gathering, and then interpreting, the data does

have a cost even in our more technological age. Further, investors do have a right to confidentiality in their transactions unless there is a strong enough reason to gather the data.

Based on this information, the Fed might, over time, begin to place restrictions on certain activities by asset manager SIFIs. It is impossible to say at this point what restrictions might be instituted, because it would depend on conclusions reached by the Fed about dangers to the system, which might themselves change as the state of the financial system and larger economy evolves.

A crucial question is whether the Fed would institute capital requirements. Dodd-Frank effectively mandates capital requirements for non-bank SIFIs, as already exist for bank SIFIs. However, there may be room for the Fed to apply this loosely in cases where it did not actually make sense. For example, if a fund is designated as a SIFI, it would be possible to view all of the funds invested by shareholders into the fund as capital.

It would be worrisome if the Fed imposed broad capital requirements on SIFI asset managers, unless there was an interpretation that rendered it easy for typical asset managers to meet. Capital is largely inappropriate as a concept for asset managers, since they act as agents and not financial intermediaries in their own right. For example, an equity mutual fund that is part of a large mutual fund family could suffer very significant losses, especially if it is concentrated in particular sector. However, there is no expectation by the investors or anyone else that the fund management company would step in to absorb some of the losses. Nor would other funds in the same family do so, as they are forbidden by law from mingling their profits and losses across the funds in this manner. Absent such an expectation of loss-sharing, it is difficult to see why capital would be needed. Further, holding such capital would require an increased return for the fund manager sufficient to compensate its own equity investors who supplied the capital. This return would have to be extracted from the investors in the funds under management through higher fees. Thus, investors in the individual mutual funds would suffer higher costs with no particular benefit.

There is potentially more of a case for an adequate capital cushion for those asset management vehicles that use debt leverage. For example, if a hedge fund chooses to use high levels of debt in order to magnify its gains and losses, then whoever is supplying the credit should impose a limit on leverage in order to protect its own position, effectively requiring a certain portion of the assets in the fund to be available as capital. However, there does not appear to be a need for regulators to require such capital in order to protect the creditors, unless the creditor is a regulated financial institution in its own right, in which case such rules can be laid down for regulated lenders, without establishing regulations binding on the asset manager.

One could, though, argue that the end-investors in a fund ought to be protected from excessive leverage, which could be done with capital requirements. This does not seem necessary in the hedge fund example, because a hedge fund's investors are supposed to be limited to sophisticated investors who can analyze the risks and rewards and have the resources to bear any losses. (Concerns exist about whether these rules do a good job of weeding out unsuitable investors, especially now that hedge funds are being marketed to smaller investors than was historically the case. However, any such issues should be resolved by fixing those rules, rather than through excessive intervention in the activities of hedge funds.) Nor is there a good argument for the manager of the hedge fund to have substantial capital requirements, since they are not called upon to subsidize losses, except through forgoing incentive based fees.

Registered investment companies in the US, such as mutual funds, already have quite strict limits on their debt leverage, and strong disclosure requirements, in order to protect the less sophisticated investors who may choose to invest in these funds. Thus, here too it seems unnecessary to require that capital be held at the level of the fund manager. End-investors should be in a position to bear any losses, even when magnified relatively modestly by the allowable debt leverage at the fund level.

All in all, there does not seem to be a good case for capital requirements on asset managers, or their funds.

All in all, there does not seem to be a good case for capital requirements on asset managers, or their funds. The one exception would be if a hedge fund chose to operate as a near-bank, conducting traditional credit intermediation activities with high leverage and especially if substantial levels of maturity transformation are involved as well. If a fund is operating in largely the same manner as a bank or other financial intermediary, then it may be necessary to impose capital requirements to protect the financial system from potential shocks if a large asset manager performing these operations were to become insolvent or at serious risk of insolvency.

It should also be noted that SIFI designation might lead to additional fees or premiums that would be charged to these asset managers and ultimately their customers. For example, the FDIC's SIFI resolution fund may put a charge on the assets of all SIFIs, even those for whom it is hard to see a resolution occurring, such as asset managers. There are also proposals in Congress to place an excise tax on all SIFIs, although this could easily end up excluding certain types of SIFIs, if it ever made it through into legislation.

Appendix A: Definitions of Systemic Risk

Kaufman and Scott (2003) identify three major concepts that pervade the literature on systemic risk, and thus they offer three definitions.[50] The first definition hinges on the concept of "macroshocks" that produce simultaneous, widespread, adverse effects on the broader economy or system. In this concept, the focus is on an *event* that affects "the entire banking, financial, or economic system."[51] Systemic risk is specifically the "likelihood" of an "event that disrupts information in financial markets, making them unable to effectively channel funds."[52]

The second definition relates to the mechanism through which local financial problems are transmitted to the broader system; specifically, in this definition systemic risk is the "probability that cumulative losses...from an event...sets in motion a series of successive losses along a chain of institutions or markets."[53] This concept is drawn on by the Bank of International Settlements in their definition of systemic risk: "The risk that the failure of a participant to meet its contractual obligations may in turn cause other participants to default with a chain reaction leading to broader financial difficulties."[54] Kaufman and Scott (2003) distinguish this concept from that of macroshocks, noting that "unlike in the... macroshock definition, only one bank need be exposed in direct causation to the initial shock."[55]

The concept underlying the third definition offered by Kaufman and Scott (2003) is similar to that in the second insofar is it concerns transmission mechanisms but is different in that it "does not involve direct causation and depends on weaker and more indirect connections."[56] Under adverse market conditions, such as in the case of the failure of a large financial firm, uncertainty about the values and levels of risk exposure of other market participants is raised. In such situations, information on the levels of risk exposure may be unavailable, imperfect, or costly. As a result, a flight to safety may occur in which risk-averse market participants immediately transfer funds to safer units without conducting a complete analysis; that is, funds are transferred without properly differentiating between solvent institutions and insolvent ones, making the situation dangerous and difficult to contain.[57] Moreover, such runs may exert downward pressure on prices of securities in the affected markets, potentially creating liquidity problems and a channel for further spillover effects into banks and markets not directly affected by the initial shock.

In DeYoung's (2012) characterization and discussion of systemic risk, the concepts of macroshocks, credit crunches, and interbank connections interact with one another. In DeYoung's explanation, if banks are exposed to a common macro-economic shock, the collective weight of the damage to the banking system can cause a reduction in the aggregate supply of loans, creating a credit crunch. In turn, a feedback loop between the credit crunch and poor economic performance may arise. Furthermore, some banks may act as counterparties in money markets, derivatives contracts, and other financial arrangements, creating a source of contagion within the banking system.

Finally, in Hansen's (2012) chapter on issues of measuring and identifying systemic risk, he describes three generally recognized notions of systemic risk. First, systemic risk is often interpreted as a "modern-day counterpart to a bank run triggered by liquidity concerns." Second, systemic risk is often used to describe the "vulnerability of a financial network in which adverse consequences of internal shocks can spread and even magnify within the network." And third, systemic risk commonly refers to the possibility of "insolvency of a major player in or component of the financial system."[58]

Appendix B: Measurements of Systemic Risk

The following is an incomplete survey of the various measures of systemic risk.

The tail measurement approach involves measuring "co-dependence in the tails of equity returns to financial institutions."[59] Co-dependence is the operative concept in this approach as the measurement must "distinguish the impact of disturbances to the entire financial sector from" those that are "firm-specific."[60] A form of the tail measurement approach is applied by Adrian and Brunnermeier (2011) in their measure of systemic risk, which they call *CoVar* - the value at risk (*VaR*) of the financial *system* conditional on institutions being under distress.[61]

Contingent claims analysis is another approach. It builds on option pricing theory for firm financing - that is, equity is treated as a call and debt as a put - and estimates risk-adjusted sectoral balance sheets. In the International Monetary Fund's *2009 Global Financial Stability Review*, the contingent claims approach model is highlighted as a way of obtaining "useful and timely indicators of default probability and credit risk."[62] Jobst and Gray (2013) apply an advanced version of the contingent claims approach in order to generate aggregate estimates of the joint default risk of multiple institutions conditional on tail risk expectations in a forward-looking framework that they call Systemic Contingent Claims Analysis ("Systemic CCA").[63]

Network models focus on complex interconnections within the financial system and shed light on the "systemic implications" of those connections.[64] In the IMF's *2009 Global Financial Stability Review*, four general and complementary approaches to assessing systemic linkages are presented:

- The Network Approach tracks the reverberation of a credit event or liquidity squeeze throughout the banking system via direct linkages in the interbank market
- The Co-Risk Model assesses systemic linkages among financial institutions under extreme events
- The Distress Dependence Matrix examines pairs of institutions' probabilities of distress, taking into account a given set of other institutions
- The Default Intensity Model measures the probability of failures of a large fraction of financial institutions due to both direct and indirect systemic linkages

Notably, the relationship between network structure and systemic risk is ambiguous a priori. In a model developed by Allen and Gale (2000), complete networks, in which all banks lend to and borrow from one another, fare better than incomplete networks, in which each bank can only borrow from one neighbor and lend to only one other neighbor, in handling liquidity shocks.[65] Yet in a recent lecture given before the American Economic Association and the American Finance Association, Janet Yellen called this result "incomplete" and raised the issue that more complex networks tend to be more opaque than less complex ones, possibly lending to information problems.[66]

Other measures may be more microprudential in nature, focusing on specific financial sectors or institutional varieties.[67] Chan et al (2006a, 2006b), for instance, focus their analysis on hedge funds. Looking at the industry from both an individual and an aggregate level, the authors develop several risk measures, such as on illiquidity risk exposure, hedge fund liquidation probabilities, and aggregate volatility. In general, the authors focus on two themes in their work: illiquidity exposure - since illiquid portfolios are prone to larger price impacts from forced liquidations of positions - and time-varying hedge fund correlations.[68, 69]

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